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Summary of the economic and social survey of Asia and the Pacific, 2006

Summary

According to the *Economic and Social Survey of Asia and the Pacific 2006*, global economic growth slowed to 3.2 per cent in 2005, down from the record growth rate of 4.0 per cent in 2004. The growth rate of developing countries in Asia and the Pacific also decelerated moderately in 2005. The slowdown in the global economy and in developing countries in the Economic and Social Commission for Asia and the Pacific region was the result primarily of high and volatile oil prices and a softening of global trade. More expensive oil also heightened inflation in the region; however, overall price pressures remained mild by historical standards.

Prospects for 2006 indicate that gross domestic product growth should maintain its current momentum while price pressures should abate slightly. This is based on the following assumptions: oil prices will not increase significantly, large global current account imbalances will not spiral precipitously and a judicious mixture of monetary and fiscal policies will preserve the growth momentum while keeping inflation in check. The region also faces the threat that avian influenza might develop into a pandemic. Other policy challenges facing the region are its fast but inequitable growth and the implementation of the multilateral trade liberalization agenda agreed at the Sixth World Trade Organization Ministerial Conference held in Hong Kong Special Administrative Region of China, in December 2005.

The Asian and Pacific region also needs to address the twin problems of unemployment and underemployment. The incidence of unemployment appears to have increased despite rapid growth in recent years while underemployment remains more serious than unemployment, especially in rural areas. Even within the ranks of the employed the vast majority of workers earn paltry wages and thus remain vulnerable to internal and external shocks. A disturbing aspect of the problem is the

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phenomenon of youth unemployment, which appears to be on the rise. Governments thus need to take a number of initiatives to improve the functioning of labour markets, specifically to enhance youth employment, and improve the productivity and earnings of all workers. For their part, employers need to display better corporate responsibility by providing training opportunities for their workers to enable them to enhance their skill levels in today's rapidly changing global economy.

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I. Implications of recent economic and social developments

1. The *Economic and Social Survey of Asia and the Pacific 2006*[1] analyses trends in the regional economy against the background of global developments and outlines the main policy issues facing the region. The 2006 *Survey* also considers unemployment in Asia and the Pacific and examines the actions that Governments can take to deal with the problem.

2. The global economy grew by 3.2 per cent in 2005, down from the record growth rate of 4.0 per cent in 2004. Notwithstanding the slight deceleration, economic performance in 2005 was remarkable in view of an economic environment made increasingly adverse by high and volatile oil prices, widening current account imbalances and a softening of global trade. Growth in 2005 was driven essentially by the strong performance of China and the United States of America.

3. The economic growth rate of developing countries in the Economic and Social Commission for Asia and the Pacific (ESCAP) region decelerated moderately in 2005 (see table). This was the result largely of high oil and commodity prices and the global trade slowdown. More specifically, from an ESCAP perspective, 2004 and 2005 were characterized by a cyclical downturn in the world's information and communication technology (ICT) industry, in which many economies in the region enjoy considerable competitive strength. The rise in oil and other commodity prices, however, increased the level of inflation in 2005 relative to 2004, although the increase in prices throughout the region remained mild by historical standards. Economies overall adjusted well to the higher oil and commodity prices, some attenuating the effects of the latter with continuing subsidization of oil products and others pre-emptively tightening monetary policy in order to dampen inflationary expectations.

4. The current momentum of output growth in the ESCAP region should continue in 2006 while price pressures are likely to abate despite continuing high energy and commodity prices. The following paragraphs provide a brief overview of conditions and prospects for each subregion and groups of countries and outline the main issues confronting them.

5. East and North-East Asia achieved an impressive average economic growth rate of 6.8 per cent in 2005 led by China, which grew by 9.5 per cent in the year as a whole after having achieved double-digit growth in 2004. However, the intention of China to lower demand in "overheated" sectors and the continuing impact of high oil prices could cause the 2006 growth rate for the subregion to dip slightly. The other main economies of the subregion, principally the Republic of Korea and Taiwan Province of China, are leading exporters of ICT and electronic goods. With the global ICT and electronics cycle having bottomed out in the second half of 2005, prospects for increased ICT exports in 2006 are positive and the ICT-exporting economies are expected to grow at a higher rate in 2006 compared with 2005.

[1] *Economic and Social Survey of Asia and the Pacific 2006* (United Nations publication, Sales No. 06.II.F.10.

Rates of economic growth and inflation in selected Asian and Pacific economies, 2003-2006

(Percentage)

	Real GDP				*Inflation*[a]			
	2003	*2004*	*2005*[b]	*2006*[c]	*2003*	*2004*	*2005*[b]	*2006*[c]
Developing economies of the ESCAP region[d]	6.5	7.4	6.6	6.5	4.8	4.7	4.8	4.4
East and North-East Asia	6.5	7.7	6.9	6.5	1.4	3.2	2.2	2.2
China	10.0	10.1	9.6	8.4	1.2	3.9	1.9	2.0
Hong Kong, China	3.2	8.1	7.5	5.4	-2.5	-0.4	1.1	1.6
Mongolia	5.6	10.6	6.0	6.0	4.6	11.0	10.0	6.0
Republic of Korea	3.1	4.6	3.8	4.9	3.6	3.6	2.8	2.9
Taiwan Province of China	3.3	5.7	3.8	4.1	-0.3	1.6	2.3	1.6
North and Central Asia	7.5	7.4	6.9	6.1	12.9	10.2	12.0	9.9
Armenia	13.9	10.1	13.9	7.0	4.8	6.9	0.6	3.0
Azerbaijan	11.2	10.2	26.4	24.8	2.2	6.7	9.6	7.4
Georgia	11.1	6.2	7.7	9.0	4.8	5.7	8.2	3.0
Kazakhstan	9.3	9.6	9.2	8.6	6.4	6.9	7.6	6.7
Kyrgyzstan	6.7	7.1	-0.6	3.0	3.1	4.1	4.3	4.7
Russian Federation	7.3	7.2	6.4	5.7	13.7	10.9	12.7	10.3
Tajikistan	11.0	10.6	6.7	6.8	17.1	6.8	7.8	7.3
Turkmenistan	13.0	9.0	11.0	9.0	6.5	10.0	10.5	11.0
Uzbekistan	4.2	7.7	7.2	7.0	13.1	1.7	7.1	7.4
Pacific island economies	3.0	3.3	2.7	3.0	10.7	3.0	2.2	3.4
Cook Islands	3.1	3.4	3.2	3.0	2.0	0.9	2.9	2.0
Fiji	3.0	4.1	1.7	2.0	4.2	3.3	3.0	3.0
Papua New Guinea	2.9	2.9	3.0	3.5	14.7	2.1	1.0	3.4
Samoa	3.3	3.7	5.6	3.0	0.1	11.7	7.8	3.0
Solomon Islands	5.3	5.0	2.9	2.6	10.0	7.1	6.2	5.0
Tonga	3.1	1.6	2.8	2.8	11.6	11.0	9.6	9.0
Vanuatu	2.4	3.2	2.9	2.2	3.0	1.4	2.5	2.5
South and South-West Asia[e]	7.3	7.4	7.0	7.0	10.4	6.5	7.0	5.7
India	8.5	7.5	8.1	7.9	3.9	3.8	4.5	4.0
Iran (Islamic Republic of)	6.7	4.8	5.0	7.4	15.6	15.2	14.5	11.5
Pakistan	5.1	6.4	8.4	7.0	3.1	4.6	9.3	8.0
Sri Lanka	6.0	5.4	5.5	6.0	6.3	7.6	11.6	6.4
Turkey	5.8	8.9	5.0	5.0	25.3	8.6	7.7	5.8

	Real GDP				*Inflation*[a]			
	2003	*2004*	*2005*[b]	*2006*[c]	*2003*	*2004*	*2005*[b]	*2006*[c]
South-East Asia	5.0	6.4	5.4	5.9	3.1	3.9	5.8	6.0
Indonesia	4.9	5.1	5.6	6.2	6.6	6.1	10.5	11.4
Malaysia	5.4	7.1	5.2	5.9	1.2	1.4	2.9	2.8
Philippines	4.5	6.0	4.8	5.2	3.5	6.0	7.6	7.0
Singapore	1.4	8.4	6.4	6.0	0.5	1.7	0.4	1.2
Thailand	6.9	6.1	4.5	5.7	1.8	2.8	4.5	4.0
Viet Nam	7.3	7.7	8.4	8.0	3.1	7.8	8.4	7.4
Least developed countries	5.6	6.1	5.2	5.8	4.7	5.8	6.3	6.6
Bangladesh	5.3	6.3	5.4	6.0	4.4	5.8	6.5	7.0
Bhutan	6.8	8.7	8.8	8.0	2.1	4.6	5.5	5.0
Cambodia	7.1	7.7	6.3	6.1	0.5	5.6	5.5	3.5
Lao People's Democratic Republic	5.8	6.5	7.2	7.5	15.5	10.5	8.0	7.0
Myanmar	13.8	5.0	4.5	3.5	8.0	—	—	—
Nepal	3.1	3.7	2.6	4.5	4.8	4.0	4.5	5.0
Developed economies of the ESCAP region	1.9	2.4	2.5	2.1	-0.1	0.2	0.0	0.5
Australia	3.3	3.3	2.5	3.2	2.8	2.3	2.8	2.9
Japan	1.8	2.3	2.5	2.0	-0.3	0.0	-0.3	0.3
New Zealand	3.8	4.4	2.2	2.0	1.8	2.3	2.8	3.0

Sources: Economic and Social Commission for Asia and the Pacific, based on national sources; International Monetary Fund, *International Financial Statistics (CD-ROM)* (Washington, D.C., IMF, 2005); Asian Development Bank *Key Indicators of Developing Asian and Pacific Countries 2005* (Manila, 2005 and 2006); Economist Intelligence Unit, *Country Reports* and *Country Forecasts* (London, 2005 and 2006), various issues; and website of the Commonwealth of Independent States Interstate Statistical Committee, http://www.cisstat.com, accessed on 9 January and 10 February 2006.

[a] Changes in the consumer price index.

[b] Estimate.

[c] Forecast/target.

[d] Based on data for 38 developing economies representing more than 95 per cent of the population of the region (including the Central Asian countries); GDP figures at market prices in United States dollars in 2000 (at 1995 prices) have been used as weights to calculate the regional and subregional growth rates.

[e] The estimates and forecasts for countries relate to fiscal years defined as follows: fiscal year 2004/05=2004 for India, the Islamic Republic of Iran and Myanmar and fiscal year 2003/04=2004 for Bangladesh, Nepal and Pakistan.

6. The relaxation by China of its exchange rate regime in 2005 is unlikely to reduce its competitive advantage in exports in view of the limited extent of the currency appreciation so far. However, the large current account surpluses, exceeding in aggregate $190 billion in 2005, are expected to be somewhat smaller in 2006 as a consequence of rising oil prices and the likely appreciation of currencies in the region against the dollar. Although growth in China currently is being driven increasingly by investment and private consumption and less by net exports, overall

growth prospects in the subregion by contrast remain tied to the international trade cycle, particularly ICT exports.

7. In 2005, the countries of North and Central Asia experienced the seventh successive year of growth in gross domestic product (GDP), the longest sustained expansion since the beginning of their transformation to a market-based economic system in 1992. Positive growth was recorded virtually across the subregion in the first eight months of 2005, with Azerbaijan registering remarkable gross domestic product expansion of 20 per cent and Armenia more than 11 per cent. Although high energy and commodity prices are driving such growth rates in the subregion, domestic demand is also playing an important role, with retail turnover growing strongly in Azerbaijan, Kazakhstan, the Russian Federation and Tajikistan in 2005.

8. The strong gross domestic product growth in much of the subregion in 2005 was underpinned by continuing growth in external trade and foreign investment. Owing largely to increased global energy prices, the merchandise exports of Kazakhstan and the Russian Federation to countries not belonging to the Commonwealth of Independent States (CIS) increased significantly in 2005. The trade surplus of the Russian Federation reached $120 billion in 2005 compared with $80 billion in 2004. High energy prices also led to a large increase in the trade surplus of Kazakhstan. However, all other economies in North and Central Asia saw their trade deficits deepen owing to strong growth in the import of intermediate and capital goods, food and raw materials. In Azerbaijan and Georgia the construction of oil and gas pipelines significantly increased imports from both CIS and non-CIS countries.

9. The medium- and long-term prospects for economic growth in the countries of North and Central Asia are based on continuing high energy prices. Should these persist, the Russian Federation is expected to double its gross domestic product by 2010. Kazakhstan plans to boost oil production from 60 million tons in 2004 to between 140 million and 170 million tons by 2015. The countries of North and Central Asia also plan to increase energy and hydrocarbon trade with China, India, Japan, Pakistan and the Republic of Korea; those countries hope to attract additional foreign direct investment to construct and modernize existing energy infrastructure.

10. Lack of reliable data is a major constraint in reporting on the Pacific island countries. However, indications are that, despite continued political instability in that subregion, most Pacific island economies expanded in 2005, owing mainly to the growth of tourism, ongoing diversification in agriculture and the development of the aquaculture and fishing industries. Some countries, such as Papua New Guinea, Solomon Islands and Vanuatu, should also benefit from higher prices for mineral and commodity exports, improved tourism receipts and higher remittances.

11. Political instability in some Pacific island countries affects both domestic and foreign investment as well as economic policy reform initiatives and will inevitably have an adverse impact on future economic growth. Another concern is the falling stocks of certain species of tuna in the subregion, on which several countries depend for revenue. Heavy dependence on increasingly expensive imported oil and diesel fuel is another challenge for these small and vulnerable countries. Some Pacific island countries have improved their fiscal position in recent years, which has contributed to the easing of inflation. However, the high oil prices are expected to exert pressure on overall prices in these countries and are prompting renewed

regional interest in alternative fuel sources, such as ethanol made from local sugar cane.

12. Despite rising oil prices, countries in South Asia maintained their growth momentum in 2005. Aided by normal monsoon rains, the reforms and structural changes initiated earlier are now bearing fruit. The increasing integration of the subregion into the global economy, rising consumer spending and generally supportive policies are also helping the pace of growth. Both India and Pakistan have achieved impressive growth rates in recent years. On the basis of sustained high economic growth, India is increasingly becoming a major contributor to global growth. In addition to an almost normal harvest in 2005, the strong responsiveness of the private sector to emerging opportunities has sustained robust growth in both industry and services. The capital and consumer goods sectors are performing well, indicating an improvement in consumer and investment demand. The economy of India is also benefiting from substantial inflows of foreign investment. That Government's efforts to contain the fiscal deficit despite higher public expenditures for an employment-generation programme have served to minimize the crowding out effects of Government spending on private investment. Notwithstanding the strength of domestic demand, the external sector remains a major source of strength for the economy.

13. The economy of Pakistan grew strongly in 2005 at the highest rate in the past two decades. This impressive growth rate was supported by strong growth in large-scale manufacturing, especially in textiles, a sharp upturn in agriculture and a robust performance in the service sector, especially finance. Moreover, strong growth was underpinned by supportive macroeconomic policies, growth in domestic demand, renewed confidence of the private sector, greater fiscal discipline and a stable exchange rate.

14. Both India and Pakistan are projected to maintain their current growth momentum in 2006 and beyond. All three main sectors, namely, agriculture, industry and services, are expected to contribute to the healthy growth of the two economies. It is worth noting that in October 2005 Pakistan suffered a devastating earthquake in the northern areas of the country that resulted in a major loss of life and property. The country's long-term reconstruction needs are likely to be massive, approximately $5.2 billion. There are indications, however, that the economy as a whole is not likely to lose momentum in the short term as a result of the earthquake.

15. In Sri Lanka, recent growth momentum was maintained in 2005. Growth in the agricultural and industrial sectors improved owing to favourable weather conditions supported by improvements in both export and domestic markets. The initial relief work following the December 2004 tsunami tragedy has been surpassed by longer-term reconstruction and rehabilitation efforts. Expenditures on such work could be reinforced owing to the improved earnings generated in other sectors of the economy. Consequently, a higher growth rate is projected for 2006.

16. High energy prices continue to underpin the performance of the Islamic Republic of Iran. Nevertheless, the non-oil economy and agriculture are also making significant contributions, with the private sector becoming more active in the economy. The economy of Turkey slowed sharply in 2005 primarily in response to higher energy prices, which created significant uncertainty for both investors and households. Current trends are likely to continue in both countries in 2006.

17. Across the subregion, macroeconomic stability is being maintained through budgetary discipline and prudent monetary policy, although price pressures have re-emerged in Turkey. However, the increase in inflation in Pakistan and Sri Lanka was substantial (over 4 percentage points) in 2005 compared with that of 2004. Higher oil prices and increased imports have deepened the current account deficits in the subregion. With comfortable reserves, exchange rates have remained stable but prudent macroeconomic management will be needed to prevent the deficits from becoming a problem.

18. Over the next 12 months containment of inflationary pressures amid rising oil prices has to be the principal priority. A judicious combination of fiscal and monetary policies can help in limiting increases in consumer prices. Some countries in the subregion experiencing rapid output growth are also witnessing a credit boom. It is important to remain vigilant as the containment of credit booms requires strengthened surveillance of the banking system and close scrutiny of corporate and personal borrowing if the problem of non-performing loans is to be avoided in the future.

19. In the subregion as a whole, renewed focus is being placed on the development of physical infrastructure in order to overcome past deficiencies and to accelerate future growth. Most countries have realized that they do not have adequate physical infrastructure for enhanced private investment and sustainable rapid economic growth. For example, rapid output expansion is not being matched by expansion in transport, ports, energy and water, and this contributes to a rising gap between supply and demand. From a subregional perspective considerable potential exists for mutually beneficial trade in energy and water resources to develop new, and to improve existing, transport corridors and to bolster the efficiency of transport and trade facilitation services.

20. Economic growth in the South-East Asian subregion eased in 2005 after unusually good performance in 2004, when strong global demand for manufactures, especially electronics and ICT products, had driven growth. Despite the doubling of oil prices between 2002 and 2004 and their continued rise in 2005, the region did not experience any marked increase in price pressures until the second quarter of 2005. The extensive use of oil subsidies muted the pass-through effects of higher oil prices on the cost of final goods. However, this resulted in a heavy fiscal burden which made the continuation of subsidies unsustainable from the middle of 2005. Many countries have therefore been phasing out oil subsidies and, as a consequence, inflation is likely to creep up in 2006. In general, the policy responses of individual countries to oil subsidies can be expected to influence the extent of inflation.

21. Economic growth in the subregion is expected to accelerate in 2006, as the cyclical recovery of demand for semiconductors and ICT products gathers pace and is aided by continuing growth in Japan and the United States. Within the subregion, increased imports are forecast by Malaysia and Viet Nam, the region's net oil exporters, which will benefit from high oil prices.

22. Monetary policy was tightened in response to the increasing inflationary pressures occurring after the second quarter of 2005; this firmer stance is expected to continue into 2006. Assuming that oil prices do not rise much above their 2005 levels, overall inflation in the subregion should decline marginally in 2006. Higher interest rates, aided by a degree of appreciation of the exchange rates for some currencies in the subregion, are expected to partially offset the higher prices of

dollar-denominated oil and other imports. Fiscal policy in the region is expected to be generally neutral, although Thailand is expected to continue applying a moderate amount of fiscal stimulus in 2006.

23. Economic growth in Japan accelerated in 2005. Japan is witnessing a recovery in private consumption, which is buttressing higher investment expenditures by corporations. This has been essentially a consequence of the structural reforms implemented in the banking and corporate sectors, which also improved profitability in both sectors. However, the problem of deflation continues to affect consumer sentiment in Japan while the overall tenor of macroeconomic policies is bedevilled by the country's huge public debt. Looser monetary policies are expected to help to end deflation in 2006. However, fiscal consolidation appears to be some way off and is likely to generate uncertainties vis-à-vis the real strength of domestic demand and the impact of higher interest rates on the overall fiscal outcome.

24. In the other two developed countries of the region, Australia and New Zealand, gross domestic product growth eased in 2005 compared with 2004 but remained close to its long-term trend, as strong export growth was partly offset by weaker domestic demand. A sharper decline in domestic demand and still buoyant imports in 2006 are likely to slow the New Zealand economy further. By contrast, the continued strength in exports and high commodity prices, along with subdued import demand, are likely to bring the economy of Australia back to its recent growth trend of over 3 per cent in 2006. The fiscal position of both countries remains strong owing to their relatively buoyant tax revenues. In Australia, a fiscal surplus was achieved despite substantial tax cuts. Both countries remain cautious about a build-up of inflationary pressures resulting from the rise in energy and overall producer prices and emerging capacity constraints. Interest rates have remained stable: the last rise in Australia was in March 2005 and in New Zealand, in October 2005. Moreover, consumer price inflation remains within the target ranges of the central banks of those countries.

25. Both Australia and New Zealand continue to face the problem of a sizeable current account deficit: nearly 5 per cent of gross domestic product in Australia and over 7.5 per cent in New Zealand. Financing this gap is not a significant policy issue per se, but it does serve to circumscribe both countries' freedom to manoeuvre with regard to monetary policy because it creates a floor below which interest rates cannot fall. While a number of temporary influences are at work in increasing or decreasing the current account deficit, such as repatriation of investment income by foreigners and fluctuations in commodity prices and tourist arrivals, it is the lack of domestic savings that is the fundamental cause of the current account imbalance in both countries.

26. Among the least developed countries in the region, the economy of Bangladesh has been experiencing steady growth in recent years. A slight acceleration in growth is expected in 2006, aided in part by flood-related reconstruction work and bumper crops. Steady gross domestic product growth in Bangladesh has been translated into visible progress on the social front and is reflected in the country's upgrading to the category of a medium-developed country in the United Nations Development Programme human development index. In Nepal, gross domestic product growth decelerated in 2005 owing to poor performance in both the agricultural and non-agricultural sectors. Inclement weather was primarily responsible for the slower growth in agriculture and the country's

internal conflict caused a slowdown in the broader economy. If the improved weather conditions remain steady, growth in 2006 is expected to revert to its recent trend. In Cambodia, the Lao People's Democratic Republic and Myanmar, the pace of gross domestic product growth was broadly maintained in 2005 but price pressures increased. Prospects for 2006 indicate a continuation of these trends accompanied by an easing of inflation.

27. Despite recent progress, poverty remains pervasive in most of the least developed countries in the region. Therefore, Governments need to give priority to promoting rapid and sustained economic growth. The primary goal must be to double average household living standards as quickly as possible, since the average level of private consumption per capita is so low. More than a simple expansion of gross domestic product is required. Economic growth must be based on the accumulation of capital, skills and productivity growth and the expansion of sustainable livelihoods and employment opportunities that would expand the consumption possibilities of households and individuals. While economic growth is of paramount importance for poverty reduction in the least developed countries, inequality and exclusion cannot be ignored. Efficiency-expanding redistribution of assets and income are important for sustained economic growth and poverty reduction in situations of generalized poverty.

II. Policy issues and challenges

A. Oil prices

28. Oil prices have doubled since the beginning of 2004 and have trebled since 2002. Despite the high oil prices there has been no sign yet of a global economic slowdown for three major reasons. First, the increase in oil prices has been driven mainly by strong global demand, not supply disruptions as had occurred in the past. The adverse effect on growth is far lower in a demand-driven price rise than one which is caused by a disruption in supply. Second, both inflation and inflationary expectations are lower worldwide, compared with expectations at the time of the previous oil shocks. Finally, the intensity of oil consumption and production, particularly in the middle-income developing countries, is significantly lower than in the 1980s.

29. Notwithstanding these matters, because Asia and the Pacific is highly dependent on oil, the region remains vulnerable to any significant increase in oil prices in 2006. Net oil-importing countries need to take steps to adjust to this risk, both to mitigate the adverse social impacts of high oil prices and to counter their negative macroeconomic effects. For 2006 the *Survey* has assumed that oil prices will continue to fluctuate within the range of $50-$55. There are fears, however, that oil prices could trend upwards towards $100 a barrel within the next four years.

30. A streamlining of the existing system of subsidies is clearly warranted, particularly when they do not protect the intended groups. Governments could start by phasing out subsidies on fuel types that are not widely used by the poor. For example, diesel subsidies, though widespread in the region, do not directly benefit the poor as do, for instance, subsidies on liquefied petroleum gas or kerosene. A better approach would be to replace oil subsidies with direct income-targeting instruments that would benefit the poor.

31. Least developed countries in particular face significant vulnerabilities as a result of rising oil prices. These countries have little access to alternative sources of financing to cushion them against a temporary increase in their balance of payments deficit caused by high oil prices. Thus, international financial institutions need to provide, or arrange, financial assistance for the least developed countries, as was done in the 1970s through the International Monetary Fund oil facility.

32. Net oil exporters in the region, for example those in Central Asia, also need to adjust to rising oil prices. The focus should be on how to manage oil windfalls efficiently without jeopardizing short-term macroeconomic stability, as there is likely to be pressure on the real exchange rate to appreciate.

33. Both oil-importing and oil-exporting countries need to develop a longer-term policy response to reduce oil dependency, to improve energy efficiency and to promote energy conservation. Rationalization of energy pricing, greater public awareness of alternative energy options, improved regulations to ensure a minimum level of energy efficiency and fiscal incentives to reduce energy consumption are some of the measures that have proven to be effective in various settings. Their wider application should be promoted as a matter of priority in the region.

B. External payment imbalances

34. The widening imbalances in the external accounts of major economies in the world pose a major economic risk for the ESCAP region in 2006. A precipitous spiralling of these imbalances could create large upheavals in the international financial markets and cause significant exchange rate instability not involving the dollar alone but perhaps several currencies in the region as well. Such phenomena would, in turn, have a negative impact on the regional economy by making both consumers and investors more risk averse and more likely to divert savings into real estate and precious metals even more than is currently the case.

35. There is only limited scope for action to address this problem at the national level. At the regional or international level, one approach would be to focus on the current account balances per se. Since one country's deficit is another's surplus, one policy response could be to cause the currencies to appreciate in surplus countries while they depreciate in deficit countries. As a result, deficit countries would improve their export competitiveness and thus improve their current account balances. The opposite would be true for surplus countries. However, such a response may not prove effective in view of the fact that the price elasticities of internationally traded goods tend to be limited in the short term and consumer choice is not a matter of price alone. Moreover, exchange rate changes are not simply matters of administrative fiat.

36. A more appropriate policy approach would be to regard current account imbalances as a reflection of structural imbalances between domestic savings and investment. Those countries with excess savings compared to investments tend to run current account surpluses. The opposite is true for countries with low savings. Remedying the imbalances therefore requires higher investments in the surplus countries and higher savings in deficit countries, the United States in particular; however, significantly raising the levels of savings and investments cannot be done over the short term.

37. Given the widespread negative implications of an abrupt and large-scale spiralling of global current account imbalances if left to the financial markets alone, there is a need, too, for a concerted regional response, if not a global one. Rather than trying to correct imbalances that may lead to sharp contractions in the wider regional or global economy, a more effective solution would be one that strives for a balanced, medium-term approach, with exchange rate adjustments effected over a period of time within an agreed regional framework.

38. Within such a framework countries in the region with current account surpluses would need to significantly bolster investment in their economies. There is obvious scope for increased investment in the region, particularly in view of the enormous need for new investment in infrastructure, both physical and social.

C. Impact of higher interest rates

39. An important issue with which economies in the region would have to deal in 2006 is the potentially adverse impact on growth of a combination of tighter fiscal and monetary policies. For a number of years, many countries have been following a policy of fiscal consolidation with a view to reducing the growing burden of public debt and providing more space for private investment activity. Inflationary pressures induced by high oil prices have resulted in a tightening of monetary policy and rising interest rates across the region, although there are some notable exceptions. Reinforcing the effects of long-term fiscal consolidation, especially in countries where it is being brought about through cuts in Government expenditure rather than through improved tax revenues, higher interest rates are bound to affect the pace of economic activity. In fact, a particular danger exists in those countries where low interest rates have fuelled strong growth in debt-financed private consumption and created asset bubbles.

40. In this regard, higher interest rates should prove less deleterious for economic growth than cuts in Government spending, especially in the poorer developing countries where Government development expenditure is often the key to the pace of development. However, in the richer developing countries where real interest rates are already high, a further significant increase could result in a hard landing for the economy through a sharp drop in asset prices. The policy challenge therefore is to judiciously mix fiscal and monetary policies in order to ensure steady output growth over the next 12-18 months. Most investors value policy predictability; Governments should therefore develop medium-term scenarios for gross domestic product growth, inflation, budgetary and balance-of-payments outcomes through a process of consultation with all relevant stakeholders.

D. Avian influenza

41. Avian influenza is a viral infection primarily affecting birds but sometimes also mammals, including humans. Until recently, the current outbreak of avian influenza had affected mainly poultry in East and South-East Asia. Between December 2003 and February 2006, there were 161 human cases in the region with 86 deaths. No vaccine is currently available to protect humans from avian influenza.

42. The estimates of deaths from a possible global pandemic of highly pathogenic avian influenza range from 5 million to 150 million people. As a conservative

estimate, the global loss in gross domestic product from a pandemic could amount to $200 billion in just one quarter and in a worst-case scenario could plunge the global economy into recession. The costs of dealing with the wider spread of the disease have so far been around 0.1 per cent of gross domestic product. However, should it emerge in the form of a pandemic involving rapid human-to-human infection, the influenza would inevitably cause massive disruption to everyday life through widespread quarantines and travel restrictions and impose a huge burden on public-health budgets.

43. Given these risks, there is an urgent need for collective preparedness in the region involving the stockpiling of medical supplies and taking joint action on possible control measures, such as travel restrictions, to minimize the spread of the disease. It is also important from the standpoint of cost-effectiveness to concentrate resources and action on controlling the disease at the source before it develops into a more rapidly spreading contagion.

E. Ongoing challenge of poverty

44. Although the Asian and Pacific region has been growing faster economically than most parts of the world for two decades or more, the eradication of poverty remains its most important challenge. In tackling the problem of poverty it is important to remember that rapid economic growth remains the surest route for reducing both income poverty and non-income poverty. Rapid economic growth provides opportunities for employment in both the formal and informal sectors of an economy and it generates resources for the public sector. In this manner, issues of non-income poverty, such as insufficient or poor-quality public goods, namely education, health, transport and housing, can be meaningfully addressed.

45. However, rapid growth alone may not be enough. It appears that in countries where poverty is widespread, jobs and income growth alone will not have a positive impact on non-income poverty. In such cases, the Governments concerned need to intervene to make the growth process more equitable by expanding the provision of and access to public goods, particularly for and by the poor.

46. Inequitable growth is an important issue in many smaller economies, including least developed countries and Pacific island States. In such economies, national efforts can be severely undermined by the paucity of financial and non-financial resources and further eroded by physical remoteness, as in the case of the Pacific island countries. In such countries, without regional and, indeed, international aid and support, such as the global compact envisioned in the eighth Millennium Development Goal, the prospects for sustained long-term growth and, hence, for reducing poverty, are very limited. In that broad context, the temporary movement of workers on contract employment abroad is an option with considerable potential for reducing poverty.

F. Remittances

47. Remittances sent by migrants and temporary workers on contract abroad to their families have greatly helped to raise the standard of living of some of the poorest sections of society in South Asia, South-East Asia and the Pacific region. Countries with high levels of underemployment and with limited opportunities for

formal sector employment could follow the example set by the Philippines and systematically promote the temporary export of workers as part of a national development and poverty-reducing strategy.

48. Equally, countries facing general labour shortages or shortages of people with specific skills should actively consider allowing migrant workers to work legally in their economies without fear of harassment.

G. World Trade Organization agenda

49. The Sixth World Trade Organization Ministerial Conference, held in Hong Kong Special Administrative Region of China, in December 2005, concluded with the adoption of a wide-ranging Ministerial Declaration. New elements in the Declaration include the following:

- An end to all agricultural export subsidies by the end of 2013, with progressive phasing-out such that a substantial number of subsidies would be phased out by the end of the first half of the implementation period, as well as an end to all export subsidies for cotton by developed countries in 2006.
- For non-agricultural market access, higher tariffs will be reduced more steeply than lower tariffs, thus leading to a more harmonized (flatter) tariff structure across all World Trade Organization members.
- Duty-free and quota-free access "on a lasting basis" by developed and developing countries declaring themselves in a position to do so, for at least 97 per cent of exports (as defined at the tariff line level) from the 32 least developed countries that are World Trade Organization members, by 2008 or no later than the start of the implementation period. However, the products most likely to fall into the 3 per cent category are those very products in which least developed countries are the most competitive and for which they would stand to gain the most from unfettered access to developed markets: textiles and clothing products from the least developed countries in Asia and the Pacific would feature prominently in this category. Notwithstanding these concerns, this measure represents a step forward on an issue that has been on the agenda for more than a decade.
- Intensification of the request-offer negotiations in services, which remain the main method of negotiation, with a view to securing substantial commitments. A second round of revised offers is to be submitted by 31 July 2006, while a draft schedule of commitments in services is scheduled for completion by 31 October 2006.

50. While the Declaration puts the Doha round back on track, an issue of fundamental importance is whether it holds the promise that the Doha round will ultimately correct the development deficit of the Uruguay round. A key challenge facing ESCAP members and associate members over 2006 will be how to reinvigorate the Doha development agenda.

51. Developing economies in the ESCAP region are likely to be challenged in the months ahead to make concessions of a commercial value so that developed countries will remain committed to the process. Thus, the challenge facing the trade-dependent economies of the region is how they might harness the traditional

reciprocity dynamics of the World Trade Organization to move forward on their market access expectations. At the same time, a jump-start from the region is needed to open up the service sector, and efforts made in this regard by one or two increasingly dynamic service exporters from this region would be worthy of further support by other developing economies of the region.

III. Emerging issues of unemployment in the region: rising to the challenges

52. The number of people unemployed in East Asia increased from 4 million in 1992 to 9 million in 2002, while in South-East Asia and the Pacific the number increased from 5.5 million to 14.6 million. Total unemployment increased by 7 million in South Asia over the same period. The rate of unemployment increased from 2.5 per cent in 1994 to 3.6 per cent in 2004 in East Asia and from 4.1 per cent to 6.4 per cent in South-East Asia. South Asia experienced an increase in the unemployment rate from 4.0 per cent to 4.8 per cent during the same period. The phenomenon of underemployment, particularly in rural areas, is even more widespread than unemployment itself. Sadly, the region also harbours an estimated 127 million, or 52 per cent, of the world's 246 million working children between the ages of 5 and 14.

53. Over the years, the economic structure of the region has moved towards employment in manufacturing and services and away from agriculture. However, the share of employment in the agricultural sector vis-à-vis total employment, particularly in large economies, remains high. In many countries the rural informal economy still provides the majority of employment opportunities; however, such employment tends to prefer male workers. The changing structure of the regional economy has also resulted in a widening wage gap between skilled and unskilled workers.

54. There are two main reasons for the high rates of unemployment and underemployment. First, the labour-force growth rate is high. It grew by 2.4 per cent per year in South-East Asia and the Pacific and by 2.2 per cent in South Asia during the past decade, owing to several factors: high birth rates, increasing female participation rates and extended working ages. Second, the pace of job creation has not kept up with the growth in the labour force. In addition, there has been lower demand for labour as a result of technological change and the considerable downsizing that has occurred in public-sector employment following privatization.

55. There is now widespread concern that many countries in the region are achieving high output growth at the expense of employment creation. Jobless growth is occurring, particularly in rapidly growing economies where the rate of unemployment has tended recently to rise.

56. A large share of those employed in the region earn paltry wages. The share of the working poor measured in terms of employees earning less than $2 a day (defined in terms of purchasing power parity) as a share of total employment was as high as 88 per cent in South Asia in 2003, 59 per cent in South-East Asia and 49 per cent in East Asia. These figures indicate that the vast majority of the people employed in these subregions earn wages that are just above the $1 a day poverty

line. As a result, the likelihood is very high that the working poor could fall prey to internal or external shocks and slide into extreme poverty.

57. Unemployment in the region is highly concentrated among youth. For example, while the overall unemployment rate in the region was about 4.4 per cent in 2004, the rate of youth unemployment varied between 7.5 per cent in East Asia and 17.1 per cent in South-East Asia. The rate more than doubled in South-East Asia, from just under 5 million in 1994 to nearly 10.5 million in 2004. South Asia has the largest number of unemployed youth, at almost 14.5 million in 2004.

58. Improving the functioning of labour markets is of vital importance in order to tackle the problem of unemployment. In the formal sector, the region's labour markets are excessively rigid owing to the non-transferability of pension benefits, firm-specific training and strict firing regulations. The introduction of more flexible contributory pension and retirement schemes, minimum standards of education and technical skills and a relaxation of hiring and firing regulations along with better income protection for laid-off workers at the societal level could help to address these issues.

59. The low level of education and the mismatch between educational attainment and the skills demanded by the private sector are major causes of unemployment. Workers with more than a minimum level of education appear to perform better in on-the-job training, skills testing and evaluation, thus increasing their employability and job prospects.

60. Compulsory education up to a fixed age could help to address the complex issue of child labour. Where female unemployment is high or the female participation rate is low, educational reforms may help to break this vicious circle by providing a more conducive sociocultural environment for women to receive an education, to improve their productivity and to help in eliminating wage and employment discrimination against women.

61. Vocational training programmes in many developing countries of the region do not seem to receive strong technical and practical support despite the potential high returns of such programmes. There are many reasons for this, such as trainers lacking recent industrial exposure and educators lacking professionalism in curriculum development. Training programmes are most effective when they are tightly targeted and small-scale, with a strong on-the-job component and linked to industry.

62. Interventions to enhance the employability of youth should be a key component of active labour-market policies and educational reforms. Programmes facilitating labour-market entry need to target youth well in advance of their entry into the formal labour market. Career guidance and counselling and the provision of labour-market information would be useful tools in steering youth in the right direction.

63. Credible reform of public-sector recruitment and wage policies could also control high unemployment by reducing the incentives for extended job searches. Reform of such policies to eliminate the bias associated with public sector jobs perceived as "good" and create conditions for improvement in the quality of "bad" jobs would be necessary to solve the problem of people searching for public sector jobs over an extended period.

64. Although unemployment benefit schemes have major fiscal implications, they could serve as a safety net for workers during short spells of unemployment and help to make labour markets more flexible. To be more effective, unemployment benefits should be linked to the development of job skills during the period of unemployment.

65. The success of some countries such as Malaysia in stimulating employment growth through trade liberalization provides evidence of the importance of a balanced approach to economic growth and employment generation. An initial step in obtaining benefits from trade liberalization would be to improve absorptive capacity in the host country, particularly by enhancing the quality of human resources. Providing a supportive environment, both in terms of domestic reforms and enabling greater access to global markets, is also required for a country to benefit from trade liberalization.

66. To strike the right balance between high economic growth and employment creation requires steps to improve the productivity of workers in niche industries while focusing on sectors where the majority of labour is concentrated and giving particular emphasis to capacity-building. In agriculture, a number of measures would play a critical role in this respect: land reform, extension services, provision of credit, crop diversification and rural infrastructure development. Improved marketing facilities and cooperative organizations could also be effective instruments for advancing rural employment.

67. The development of microenterprises and small and medium-sized enterprises in both rural and urban areas possibly offers the greatest potential for employment generation. Therefore, this process needs to be facilitated through the provision of a conducive business environment, in particular by reducing entry costs, providing infrastructure, building capacity and good governance. The private sector in many developing countries in the region is hampered in the development of an environment conducive to business by inconsistent policies and weak implementation of relevant laws, frequent legal changes, the considerable discretionary powers of local authorities and bureaucratic harassment, complicated and lengthy procedures to register firms, stringent licensing and permit regimes and high taxation. Overcoming these constraints is essential for providing an enabling business environment in which microenterprises and small and medium-sized enterprises can develop.

68. Employers also need to display better corporate responsibility by providing opportunities for the training and retraining of workers, by collaborating with the public sector in providing opportunities for unemployed youth to obtain training and by ensuring workplace safety and the welfare of employees. Social dialogue is a key instrument for maintaining good industrial relations.

69. International migration could play a valuable role in stabilizing the labour markets of both labour-importing and labour-exporting countries. In this respect, a rule-based flow of persons under a global framework, such as mode 4 of the World Trade Organization General Agreement on Trade in Services, could help all countries to achieve tangible benefits.

70. The Commission is invited to direct the Secretariat to consider further any of the above-mentioned matters.

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Latin America and the Caribbean: economic situation and outlook, 2005-2006

Summary

The Latin American and Caribbean economy grew for the third consecutive year in 2005. Gross domestic product (GDP) expanded by an estimated 4.5 per cent, equal to a per capita GDP growth rate of almost 3 per cent. The dynamism of the global economy was behind the most outstanding feature of that period of economic growth, namely an expanding surplus on the balance of payments current account. The combination is without precedent in the region's economic history. The current account surplus for 2005 was equivalent to 1.3 per cent of GDP, exceeding the surpluses recorded for the previous two years. Major differences exist however between subregions.

Latin America and the Caribbean recorded an inflation rate of 6.2 per cent (as against 7.4 per cent in 2004), a continuation of a downward trend in this indicator for the region. Economic growth also led to a decrease in unemployment, although the jobless rate is still high. The expansion of the business cycle is expected to carry over into 2006, with an overall projected economic growth rate of 4.6 per cent.

* E/2006/100.

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I. Main trends

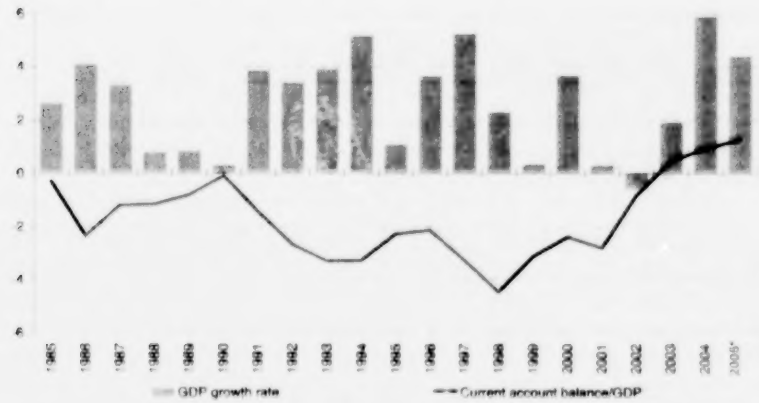
1. The Latin American and Caribbean economy grew for the third consecutive year in 2005. Gross domestic product (GDP) expanded by an estimated 4.4 per cent, equal to a per capita GDP growth rate of almost 3 per cent. The rates were lower than those recorded in 2004, but higher than the averages for the 1990s (3.2 per cent and 1.5 per cent for global GDP and per capita GDP, respectively) and the values recorded for the period 2000-2005 (2.3 per cent for GDP and 0.8 per cent for per capita GDP). Most of the economies in the region grew in 2005, though sharp differences were observed from one subregion to another (see below).

2. The expansion of the business cycle carried over into early 2006, with the economic growth rate likely to remain at around 4.4 per cent for the year overall. If projections prove correct, the average growth rate for 2003-2006 will be just over 4 per cent, while the cumulative increase in per capita GDP will be close to 11 per cent.

3. The performance of Latin American economies has not been isolated, indeed it is part of the widespread growth witnessed throughout the world economy. External demand helped to fuel another substantial rise in the volume of merchandise exports, with the price of commodities exported by Latin America and the Caribbean rising by 20.6 per cent overall, or 14.4 per cent excluding energy products. The increase was lower than the exceptionally high increase recorded in 2004, although several products clearly continued to benefit from very favourable conditions in 2005. Other markets, by contrast, suffered downward price trends.

4. The circumstances described above gave rise to the most outstanding feature of this period of economic growth, namely an expanding surplus on the balance of payments current account, a combination without precedent in the region's economic history. The current account surplus for 2005 was equivalent to 1.3 per cent of GDP, thus exceeding the surpluses recorded for the previous two years (0.9 per cent in 2004 and 0.5 per cent in 2003). Major differences exist, however, between subregions, with South America posting a current account surplus amounting to 3.1 per cent of GDP in 2005 (as against 2.5 per cent in 2004 and 2.1 per cent in 2003), while calculations for Central America and Mexico indicate a deficit of 1.7 per cent of GDP (as against 1.4 per cent in 2004 and 1.6 per cent in 2003), while the Caribbean (excluding Trinidad and Tobago, a net oil exporter) has posted a deficit of over 10 per cent on its current account for the last three years.

Figure 1
Growth in gross domestic product and balance of payments current account
(Percentage)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

* Estimate.

II. Economic policy

5. Economic policy was mainly aimed at capitalizing on good external conditions and the growth of the domestic economies to lessen the region's financial vulnerability. In particular, Latin American and Caribbean Governments took advantage of the current economic circumstances to improve their public accounts.

6. Generally speaking, the fiscal performance for the period 2003-2005 was unusual for the region. First, macroeconomic conditions helped to increase fiscal income, thanks to an upturn in activity levels and better terms of trade. Second, regional Governments avoided slipping into the usual pattern of expansionary spending on the back of better macroeconomic indicators. The two factors combined to allow central Governments to achieve a primary surplus of 1.1 per cent of GDP (measured as a simple average) at the end of 2005, compared with 0.7 per cent in 2004. The overall deficit (including interest on the public debt) dropped from 1.8 per cent to 1.6 per cent of GDP. Based on the budgets drawn up by the countries of the region, primary surpluses should continue to be high in 2006 (1.1 per cent of gross domestic product).

Table 1
Latin America and the Caribbean: central Government fiscal indicators[a]
(Percentage of GDP at current prices)

	Primary balance				Overall balance				Public debt[b]							
									Central Government				Non-financial public sector			
	2002	2003	2004[c]	2005[d]	2002	2003	2004[c]	2005[d]	2002	2003	2004	2005	2002	2003	2004	2005
Latin America and the Caribbean																
Simple average	-0.5	-0.2	0.7	1.1	-3.3	-3.0	-1.8	-1.6	56.1	54.5	50.3	42.9	61.3	59.1	53.3	45.9
Weighted average	1.3	1.7	2.2	2.3	-3.6	-1.8	-0.7	-0.9	48.2	46.5	42.9	34.6	64.8	58.2	53.7	44.1
MERCOSUR[e,f]	0.4	1.7	2.8	2.2	-3.7	-1.8	0.0	-0.9	86.3	78.4	68.4	49.4	104.7	87.5	76.4	56.2
MERCOSUR and Chile[f]	0.3	1.5	2.9	2.6	-3.2	-1.5	0.4	0.0	72.2	65.3	56.9	41.3	88.2	74.0	64.6	48.1
Andean Community[f]	-1.0	-0.5	0.1	0.4	-4.2	-3.8	-2.8	-2.6	56.2	57.6	53.4	49.0	61.7	63.9	58.3	53.4
Oil-exporting countries[f]	1.6	1.5	1.7	1.6	-2.4	-2.4	-1.5	-1.5	51.1	47.9	44.0	41.6	48.7	48.8	42.9	40.1
Other countries[f]	-2.7	-1.9	-0.9	-0.4	-5.3	-4.8	-3.7	-3.4	57.8	60.8	56.5	51.4	74.7	79.1	73.8	66.6
Mexico	0.9	1.7	1.9	2.6	-1.2	-0.6	-0.3	-0.2	24.0	24.2	23.3	22.6	27.5	27.6	26.1	25.4
Central America[f]	-0.5	-0.7	-0.1	0.4	-3.0	-3.4	-2.6	-2.3	70.2	71.0	64.0	58.7	71.7	72.8	65.8	60.4

Source: ECLAC, on the basis of official figures.
[a] Includes social security.
[b] At 31 December each year, using the exchange rate applicable to external debt. For 2005, the latest available data were used. The public debt shown for the Dominican Republic refers to external debt only.
[c] Preliminary estimate.
[d] Official targets.
[e] Common Market of the South/Mercado Común del Sur.
[f] Simple average.

7. It should be recalled that the central government fiscal balance is not entirely representative in the case of those countries of the region whose public sectors are more decentralized. Taking into account the broader public-sector accounts in Argentina, Brazil, Colombia and Mexico, the primary balance of non-financial public sectors moved, on average, from 3 per cent of GDP in 2003 to 3.6 per cent in 2004, and to an estimated 3.5 per cent in 2005.

8. The improvement in fiscal aggregates has helped to lessen the region's external vulnerability, manifested essentially in its debt indicators. This is the result of a combination of factors, among which governmental decisions and the characteristics of the business cycle figure prominently. The debt of central Governments was thus estimated at 42.9 per cent of GDP in 2005, compared to 54.5 per cent in 2003 and 50.3 per cent in 2004. The decrease in that indicator was attributable mainly to the generation of primary surpluses, debt restructuring and currency appreciation with respect to the United States dollar.

9. Although many of the countries' debt coefficients are still very high, the reduction in their public debt:GDP ratios are helping to make the region less vulnerable to external shocks. Another factor that is leading the region in the same direction is the decline in the ratio between its external debt (less its international reserves) and its exports of goods and services. While exports are rising at a considerable pace, the counterpart to the current account surplus takes the form of a

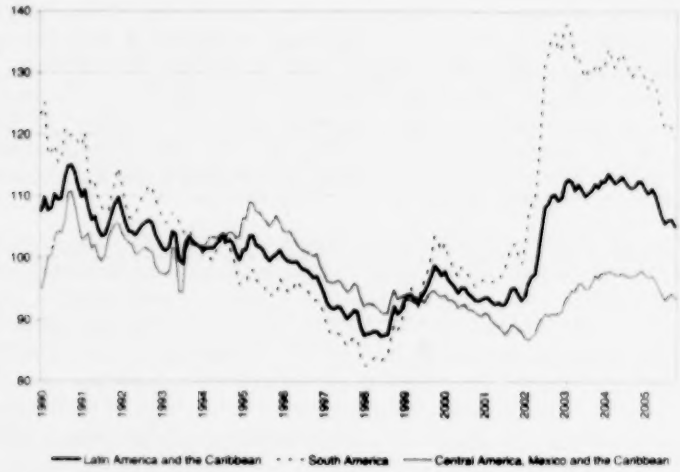
dual process, consisting of a paydown of the external debt and a build-up of reserves, which is allowing the countries of the region to reduce their net liabilities position.

10. The smaller financing requirement resulting from such a fiscal situation added to the build-up of reserves by Governments and their interest in demonstrating their ongoing commitment (without the conditions inherent in a letter of intent) to maintaining fiscal solvency, reduced the incentives to conclude standby arrangements with the International Monetary Fund (IMF). Of the region's six largest countries in terms of GDP (Argentina, Bolivarian Republic of Venezuela, Brazil, Chile, Colombia and Mexico), only Colombia had a standby agreement in place at the end of 2005. In that connection, both Argentina and Brazil have prepaid their entire debt to IMF.

11. The region continues, however, to display a number of structural features that are in need of attention. Despite rising revenue in recent years (including 2005), the region still has a weak and inequitable tax structure and shows a significant dispersion of tax burdens across different countries. On the spending side, consideration must be given to the poor quality of adjustments made in recent years, which have undermined the capacities of Governments to address the remaining problems in the region's public sectors, namely the low level of public investment, the need to improve the provision of social services and the need to remedy the serious coverage and solvency problems observed in social security systems.

12. In 2005, the extraregional real effective exchange rate (which excludes trade with other countries in the region) exhibited a year-on-year appreciation of 5 per cent, which was mainly due to the faster real appreciation (6.5 per cent) among the South American currencies, with the currency rising in value in 9 of the subregion's 10 countries. Central America, Mexico and the Caribbean exhibited a lower rate of extraregional effective appreciation (3.3 per cent), as a result of currency appreciation in eight countries. The Dominican Republic recorded a real currency appreciation of 29.8 per cent against the United States dollar.

Figure 2
Latin America and the Caribbean: extraregional real effective exchange rate
(Average for January 1990-December 1999=100)



Source: ECLAC, on the basis of official figures, and IMF.

13. As regards the total effective exchange rate, which includes trade with the other countries of the region, 10 Latin American and Caribbean countries saw year-on-year currency appreciation in real effective terms in 2005. Of those 10, 3 South American countries (Brazil, Colombia and Uruguay) registered double-digit currency appreciation, while Jamaica and Guatemala were the only Central American and Caribbean countries to see a substantial drop in their real effective exchange rates (7.4 per cent and 7.1 per cent, respectively).

14. In order to offset the trend of their currencies towards real effective appreciation, the authorities in several countries of the region (including Argentina, Colombia and Peru) intervened repeatedly in currency markets, buying large volumes of foreign currency during the year.

15. Unlike the situation in the 1990s, capital movements were not the determining factor in the cases of currency appreciation in South America in 2005. Capital inflows were recorded in a number of countries, but, according to preliminary data, the subregion registered a net outflow in 2005. Perhaps the most significant factor in 2005 was that currency appreciation in the region was influenced by terms-of-trade upturns in several South American countries, Mexico and some Caribbean countries, as well as by substantial income from emigrant remittances in several Central American countries.

16. Holding down inflation continued to be the main objective of monetary policy in the countries of the region. Given the rise in oil prices and the improved outlook for economic activity, Latin American central banks increasingly focused on inflation. Prices have, in fact, increased at a fairly moderate rate, given the generalized appreciation of local currencies, as discussed in more detail below.

17. Until mid-2004, countries that were on track towards their inflation targets were able to use monetary policy to help fuel their economies by means of successive cuts in interest rates. Thereafter, most of the countries having met those targets, many central banks cautiously raised monetary policy interest rates to avoid deviation from international rates.

18. Since then, reference rates have risen in the region, but are still relatively low in historical terms. Given the modest rise and the price increases in some countries, real interest rates have stayed virtually unchanged or have even come down in the past 30 months. Brazil and Mexico, the region's two largest countries, are two important exceptions.

19. Bank lending is relatively more important in the Latin American and Caribbean countries than in the developed world because capital markets in the region are less developed. In that regard, the upturn seen in bank credit in 2003 bore out expectations of better growth prospects, which have continued thus far. Total and private credit continued to expand at rates of over 10 per cent in 2005, thereby continuing the previous year's trend and regaining levels seen before 2001.

III. Domestic performance

20. Against a backdrop of widespread economic growth, domestic performance was particularly good in the economies of South America and, to a lesser extent, the Caribbean, where the levels of activity have risen faster than those of Central America and Mexico.

Table 2
Latin America and the Caribbean: gross domestic product
(Annual growth rates expressed as a percentage)

	2004	*2005[a]*	*2006[b]*
Latin America and the Caribbean	**5.9**	**4.4**	**4.4**
South America	**6.9**	**5.0**	**4.8**
Brazil	4.9	2.3	3.3
Southern Cone	8.4	8.3	6.5
Andean Community	9.5	6.7	5.5
Mexico and Central America	**4.2**	**3.1**	**3.6**
Central America	4.0	4.0	4.2
Mexico	4.2	3.0	3.5
Caribbean	**3.9**	**4.3**	**6.1**

Source: ECLAC, on the basis of official figures.
[a] Estimate.
[b] Projection.

21. The satisfactory regional performance was reflected in most of the countries, all of which, except Guyana, posted positive growth rates. In that context, the highest rates were registered in the Bolivarian Republic of Venezuela (9.3 per cent) and Argentina (9.1 per cent), while the lowest were in Haiti (1.8 per cent), Brazil

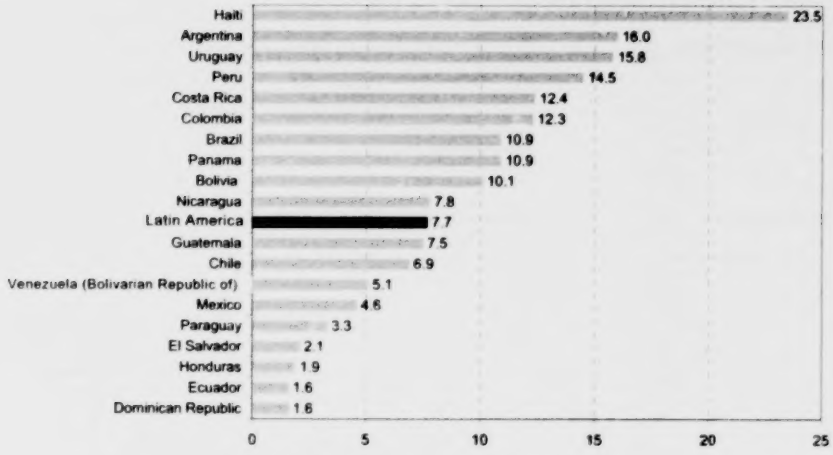
(2.3 per cent), Paraguay (2.7 per cent) and El Salvador (2.8 per cent). The growth rates of Chile, the Dominican Republic, Panama, Peru and Uruguay varied between 5.5 per cent and 7 per cent; those of Bolivia, Colombia, Honduras and Nicaragua were around 4 per cent, and those of Ecuador, Guatemala and Mexico around 3 per cent. The Caribbean countries achieved an expansion of 4.1 per cent, despite the impact of intense hurricanes; the countries that grew most in that subregion were Saint Lucia (8 per cent) and Trinidad and Tobago (7 per cent).

22. Thanks to favourable external conditions, regional economic expansion continued to be fuelled by exports. Even though growth in external demand slightly dropped, export volumes rose by 8 per cent in volume, compared to 12.4 per cent in 2004. In 2005, external sales accounted for 24.9 per cent of regional GDP, a considerable increase compared to 12.5 per cent in 1990.

23. The growth of the world economy once again had a positive impact on regional terms of trade, which improved by 4.8 per cent in 2005, slightly lower than the figure of 5.3 per cent for 2004. The positive overall trend was due to a 10.6 per cent increase in export prices, while import prices rose by 5.5 per cent. Between 2002 and 2005, regional terms of trade accumulated an increase of 13.2 per cent. The expansion was concentrated in countries that export oil, minerals and metals, while net importers of energy products suffered an even sharper decline than in 2004. There was also a sharp difference between subregions, since the South American countries had reaped the benefits of the upturns in terms of trade seen in the previous few years.

24. Fuelled by the upturn in terms of trade, gross national disposable income expanded by 5.6 per cent, calculated at the previous year's prices. In the region overall, the impact of the terms of trade was larger than in 2004, at 1.34 per cent of GDP. The larger increase in national income with respect to GDP was witnessed in most South American countries (except for Paraguay and Uruguay) and Mexico. Over the same period, gross national disposable income in Central American countries, grew more slowly than GDP, owing to the negative impact of the terms of trade.

Figure 3
Latin America and the Caribbean: estimated growth rate for merchandise exports, 2005
(Percentage)



Source: ECLAC, on the basis of official figures.

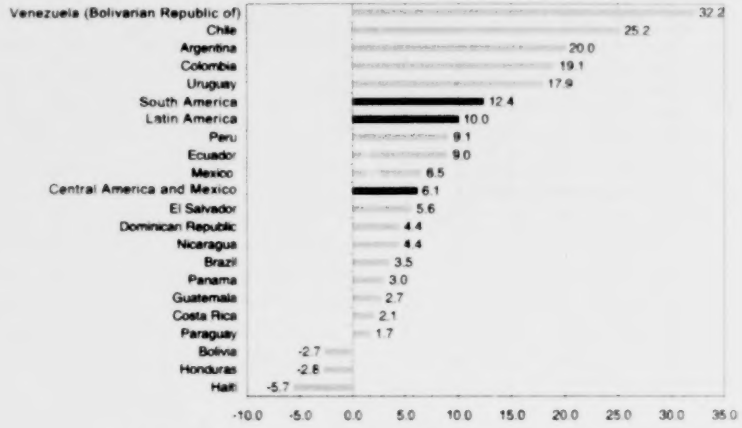
25. In 2005, the upturn in gross national disposable income in most countries helped to strengthen the recovery in domestic demand that began in 2004. As a result of that factor and of changes in exchange rates, most countries posted high growth rates for imports of consumer and capital goods. Although domestic interest rates in most cases began to follow the upward trend of international interest rates, they are still low, facilitating both investment and consumption decisions, while the exchange rate appreciations registered in some countries in 2005 helped to bring down the cost of imports, thus contributing to a higher level of domestic demand. Import volume increased by 12 per cent, making the contribution of net exports to growth in the region negative for the second consecutive year. Consumption rose by 3.3 per cent, driven by more rapid expansion of private consumption

26. With regard to the region's future growth potential, it is interesting to note that investment is climbing sharply in most of the countries (a regional average of 10 per cent). Nonetheless, since the investment rate is starting from very low levels, in 2005 it will still be equivalent to only about 22 per cent of GDP. Although the figure represents an appreciable upturn, it is still not high enough to sustain a sufficiently rapid growth rate to make any significant dent in unemployment or poverty. An examination of investment provides a clear picture of the differing economic trends in the subregions of Latin America and the Caribbean. Whereas gross fixed capital formation rose at an average rate of over 12 per cent in South America in 2005 (20 per cent if Brazil is not included in the calculations), in Central America and Mexico it rose by only 6.1 per cent, and the rate for Central America alone was just 2 per cent. The differing implications of changes in the terms of trade and, once again, uneven trends in competitiveness, have surely played a role in the differences

in investment performance in the region which, in some cases, may constrain future growth capacity.

Figure 4
Latin America and the Caribbean: estimated gross fixed capital formation, 2005

(Rates of variation based on figures in constant value of 2000 United States dollars)



Source: ECLAC, on the basis of official figures.

27. The satisfactory regional development of the components of demand was reflected in different economic sectors. The increase in mining and hydrocarbon production was in response to persistent external demand, which, together with the rise in domestic demand, continued to boost the industrial sector, thanks to the greater profitability of the tradables-producing sectors as a result of the devaluations in the biennium 2002-2003. Although in nominal terms the exchange rates have been appreciating in relation to the United States currency, in real terms they remain favourable for most of the countries of the region. The performance of the agricultural sector has been uneven, while in most countries growth in construction contributed to the higher level of gross fixed capital formation. Trade was stimulated by a rise in household consumption, while the general expansion of domestic activity gave a significant boost to the transport sector. The buoyancy of the international economy also had a positive impact on tourist-related activities. Available data for 2005 shows the number of tourist arrivals up by 13.6 per cent in Central America and 12.7 per cent in South America. In the Caribbean countries, the number of arrivals increased by 5.4 per cent over the same period, although cruise-ship tourism was affected by the hurricanes that ravaged the region, with the number of cruise ship passengers down by about 2 per cent in aggregate terms.

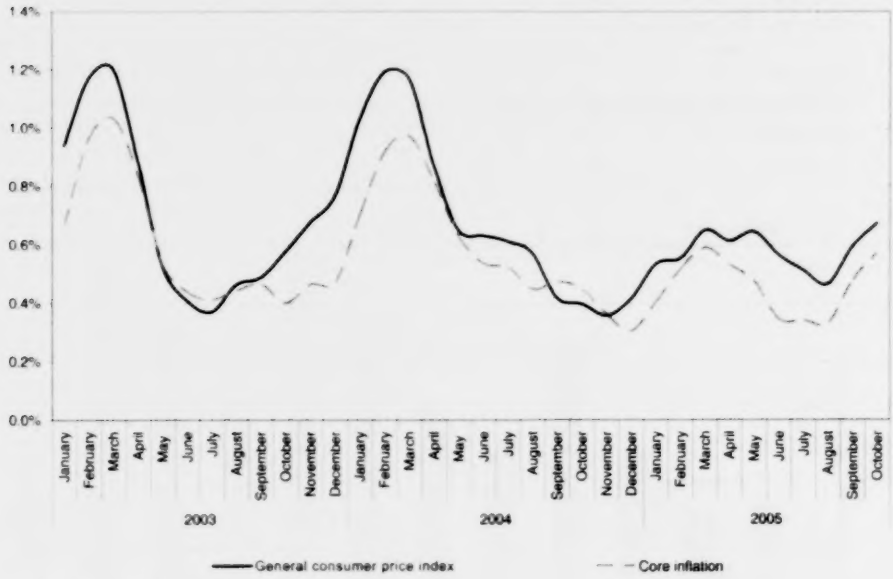
28. In 2005, Latin America and the Caribbean recorded an inflation rate of 6.2 per cent (as against 7.4 per cent in 2004), a continuation of the downward trend in the region, reflecting the drop in the inflation rates of Brazil and Mexico (5.7 per cent and 3.3 per cent, respectively, in 2005, compared to 7.6 per cent and 5.2 per cent in 2004). The inflation rate was also down in the Bolivarian Republic of Venezuela (from 19.2 per cent to 14.4 per cent), the Dominican Republic (from 28.7 per cent to

7.4 per cent), Haiti (from 20.2 per cent to 15.4 per cent), Peru (from 3.5 per cent to 1.5 per cent) and Uruguay (from 7.6 per cent to 4.9 per cent). In contrast, Argentina, Chile, Ecuador and Paraguay posted higher rates. The other countries in the region had inflation rates similar to those of 2004. Although some countries continued to post two-digit growth rates for consumer prices, for the first time no country in the region had an inflation rate higher than 20 per cent.

Figure 5

Latin America and the Caribbean: consumer price index and core inflation index

(Three-month moving average (weighted average))



Source: ECLAC, on the basis of official figures.

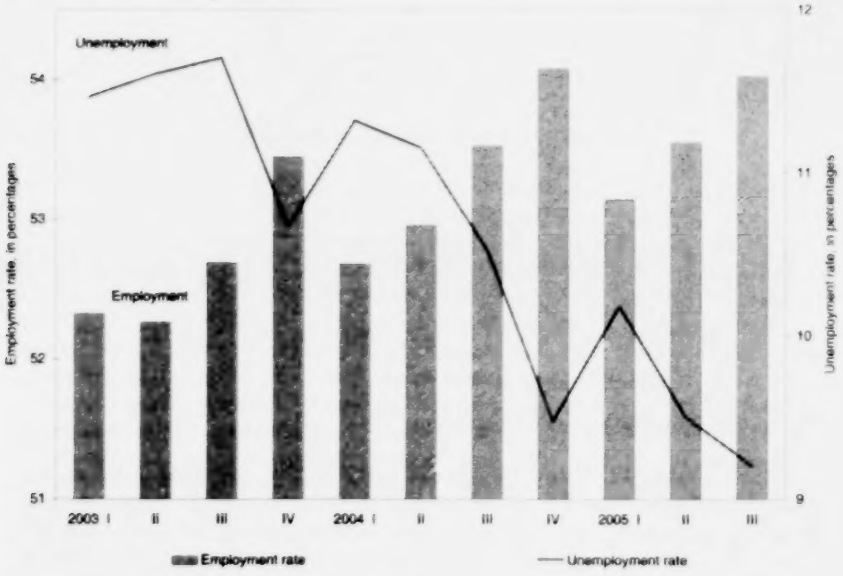
29. Domestic prices in the countries of the region in 2005 continued to follow the trends that had first appeared in the second half of 2004. In aggregate terms, the rise in international prices for foods and agricultural commodities slowed down, with the exception of coffee and sugar prices, which increased more rapidly in 2005 than in 2004. Metal and mineral prices continued to post substantial rises, although lower than in 2004. In the first half of 2005, oil and fuel prices rose more slowly than in 2004, but in the second half the trend was reversed. International prices for manufactures did not change very much in 2005. The exchange rate appreciations of the national currencies of various countries mitigated the price rises for imported products to some degree. In 2005, real salaries and wages showed varied results, with changes that were mainly too minor to cause inflationary pressures.

30. The relatively rapid rate of job creation that began in the region in 2003 continued in 2005. The employment rate was estimated to have risen by 0.5 per cent, equal to an increase of 3.3 per cent in urban employment. The accumulated increase over the three-year period from 2003 to 2005 was 1.5 per cent, a key factor in lifting 13 million people above the poverty line over the past two years.

31. While the increase in the employment rate was similar to the level recorded in 2004, the unemployment rate showed a much clearer improvement, dropping by more than one per cent to 9.1 per cent, while in the previous year it had decreased from 10.9 to 10.3 per cent. The lowering of the unemployment rate in 2005 means a 10 per cent reduction (almost 2 million people) in the number of urban unemployed. As in the case of the increase in the employment rate, the reduction in unemployment was a fairly widespread phenomenon, observed in 14 of the 19 countries for which information was available.

Figure 6
Quarterly employment and unemployment rates in nine Latin American countries

(Percentage)



Source: ECLAC, on the basis of official figures.

32. The higher level of employment was not the only reason for the drop in the unemployment rate; the reduction was also due to a significant slowdown in the labour supply. In fact, the economically active urban population grew by only 1.7 per cent (as against 2.6 per cent in 2004), owing to a reduction of 0.3 per cent in the labour participation rate of the working age population. In a number of countries, that appeared to be partly because fewer young people were joining the labour market, apparently opting to remain longer in the educational system.

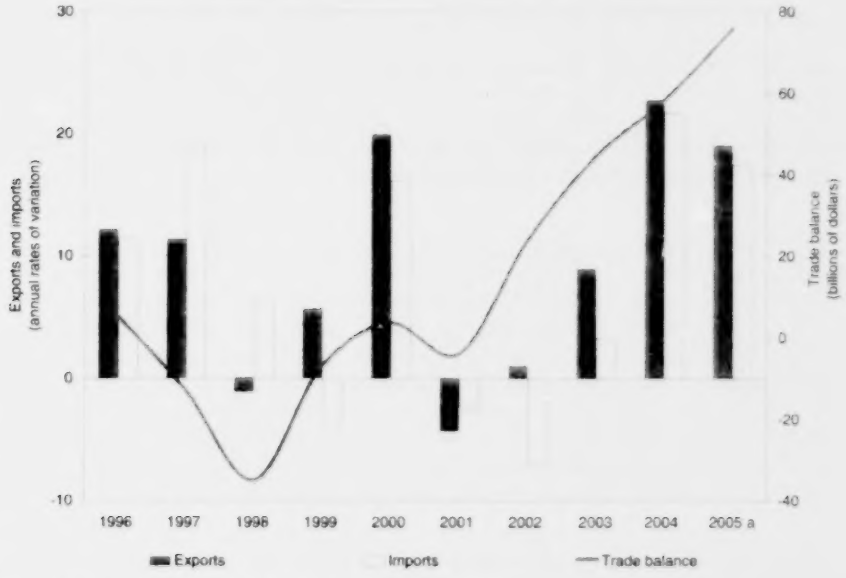
33. Most jobs created in 2005 were in the wage sector. Formal wage employment grew at high rates in a number of countries. However, there were signs of growing instability in formal employment, with a substantial increase in the number of temporary contracts.

34. In view of the persistent high unemployment rates and the restructuring of the global labour market, which has brought a massive influx of low-income workers (especially in Asia), wages stagnated in real terms in most countries. The real average regional wage in the formal sector rose by 0.2 per cent as a weighted average and 0.1 per cent in the median.

IV. External performance

35. As noted above, external conditions provided a boost to the international trade of Latin American and the Caribbean countries. In 2005, total exports plus imports amounted to more than $1 trillion dollars (49 per cent of regional GDP), while trade grew by 18.3 per cent during the year. Exports increased by 19.1 per cent and imports by 18 per cent, which represented a slight slowdown in relation to the unprecedented growth of 21.6 per cent and 20.2 per cent respectively in 2004. The merchandise trade balance, which was positive for the fourth consecutive year, stood at $77.8 billion, equal to 3.2 per cent of regional GDP ($19.4 billion higher than in 2004).

Figure 7
Latin America and the Caribbean: external trade, 1995-2005



Source: ECLAC, on the basis of official figures.
[a] Preliminary figures.

36. Export performance in the region was linked to subregional specializations. In MERCOSUR countries, external sales rose by 21.1 per cent and by 31.3 per cent in the Andean Community and Chile. In most countries, the performance of exports was largely due to strong markets for some commodities combined with the satisfactory performance of manufactured exports from Argentina and Brazil.

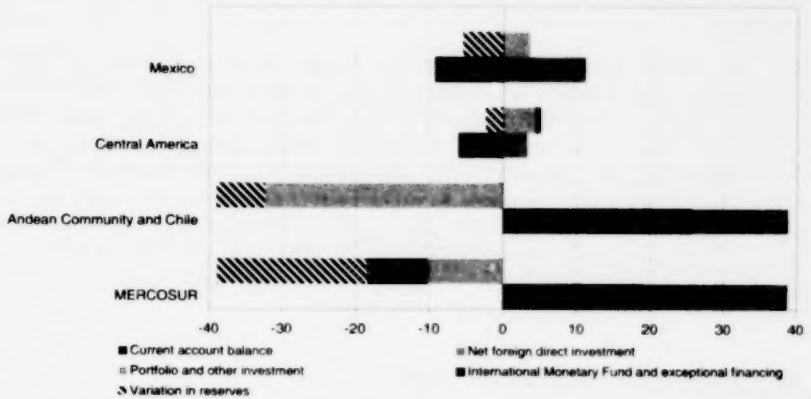
37. External sales of Mexico and Central American countries, which supply a high proportion of labour intensive manufactures, grew at rates similar to those of 2004. Some countries recorded increases, which were linked to high prices of certain traditional export commodities. Mexico's exports increased by 11.8 per cent (around 9 per cent excluding petroleum), compared with growth of 13.9 per cent in 2004.

38. Of the 19.1 per cent growth in regional exports, 10.6 per cent was due to price effects, while the rest was attributable to variations in volume. Price increases were more significant for oil producing economies (such as the Bolivarian Republic of Venezuela and Colombia) and those that produce certain minerals (such as Chile and Peru). In some of the countries that had benefited from the boom in oilseeds in 2004 (for instance, Argentina and Uruguay), volume had a greater effect on the increase in exports. Growth of export volumes reached double figures in nine economies (including Argentina, Brazil, Colombia and Peru). Mexico's export volume grew by less than the average (4.6 per cent); the country's relative size brought down the rate for the region as a whole. Other major exporters, such as the Bolivarian Republic of Venezuela and Chile, also recorded export volume growth that was below the regional total.

39. Imports also rose significantly in 2005, although somewhat less so that the previous year, partly because the expansion constituted a recovery from abnormally low levels in certain countries. Import growth was in double figures for the second year in a row: 20.2 per cent in 2004, 18 per cent in 2005.

40. For the third year in a row, the region posted a surplus on the balance of payments current account, reaching $30.6 billion (equivalent to 1.3 per cent of GDP), almost $12.2 billion more than in 2004. Over the past three years, the average current account surplus has represented 0.9 per cent of GDP, a figure unprecedented in the region's economic history.

Figure 8
Latin America and the Caribbean: estimated balance of payments components, 2005
(Billions of United States dollars)



Source: ECLAC, on the basis of data from IMF.

41. The regional surplus resulted from a positive merchandise trade balance of $77.8 billion, which was almost 30 per cent higher than in 2004. Combined with the positive current transfers balance, mainly made up of emigrant remittances ($47.6 billion), it generated a joint balance of $125.4 billion. Remittances increased considerably again in 2005 (by 14.8 per cent), while the balance of services displayed a deficit of $20 billion and the income balance deficit stood at $74.8 billion. The balance of services deficit widened, while net profit remittances from investment rose by 11.9 per cent (lower than the increase of almost 15.8 per cent recorded in 2004).

42. The good current-account results in 2005 were coupled with a positive flow of foreign direct investment into the Latin American countries as a whole. The region received flows of foreign direct investment estimated at $47 billion (2 per cent of GDP) in 2005, an increase of 4.3 per cent compared to 2004. The largest recipients were (in descending order) Brazil, Mexico, Argentina and Chile. Almost 35 per cent of inflows were estimated to correspond to greenfield investments. Notwithstanding the downturn in the region's net external liabilities position, Latin America and the Caribbean had issued international bonds worth almost $46 billion by the end of September, a sum equivalent to 29 per cent of all emerging economy issues and outstripped only by the European emerging economies, which accounted for 34 per cent of the total.

43. Seeking to lessen their external vulnerability, many countries also took steps to restructure and reduce their external liabilities. To that end, external debt was swapped for domestic (as in the case of Argentina, Colombia and Peru) and bonds

issued on the external market were redeemed (as in the case of Argentina, Brazil, Mexico, Panama and Peru). As a result, the region's external debt was expected to decrease, with a ratio of external debt to GDP of just over 30 per cent in 2005, substantially down from the 37.4 per cent of 2004. The restructuring was also directed towards increasing the proportion of total liabilities accounted for by long-term debt and by external debt denominated in local currency. The Governments of Brazil and Colombia did in fact issue local-currency bonds on the international markets.

44. The current-account balance and net foreign direct investment are used to calculate the basic balance. The balance for the region was in surplus by almost $78 billion (3.3 per cent of GDP), of which about $30.6 billion (1.3 per cent of GDP) was used to build up reserves and around $47 billion went to pay down external debt, including net payments for exceptional financing and IMF credits. Consequently, the region was able to run a current-account surplus and reduce its net external liabilities for the third year running. Although that represented a net outward flow of capital in accounting terms, the outflow was not the result of a lack of investor confidence in regional economies, as was clear from trends in the region's risk premiums, which are at an all-time low.

V. Situation and outlook for 2006

45. In 2006, the region is set to continue growing at a rate similar to that recorded in 2005, with projected growth of 4.4 per cent translating into an expansion in per capita GDP of about 3 per cent. All countries in the region, without exception, are expected to post positive growth rates, although the South American and Caribbean subregions will outpace Mexico and the countries of Central America. The inflation rate is likely to remain stable at around 6 per cent, which is similar to the level seen in 2005, although with some differences between countries.

Table 3
Latin America and the Caribbean: growth in gross domestic product, 2005-2006[a]
(Annual rates of variation)

Country	*2005[b]*	*2006[c]*
Argentina	9.2	7.0
Bolivia	4.0	3.3
Brazil	2.3	3.3
Chile	6.3	5.7
Colombia	4.3	4.2
Costa Rica	4.2	3.7
Dominican Republic	9.3	6.0
Ecuador	3.0	2.5
El Salvador	2.8	3.5
Guatemala	3.2	4.0
Haiti	1.8	2.3
Honduras	4.2	4.0

Country	*2005*[b]	*2006*[c]
Mexico	3.0	3.5
Nicaragua	4.0	4.0
Panama	6.4	6.0
Paraguay	2.7	3.0
Peru	6.6	5.6
Uruguay	6.4	4.0
Venezuela (Bolivarian Republic of)	9.3	7.0
Caribbean	**4.3**	**6.1**
Latin America and the Caribbean	**4.4**	**4.4**

Source: ECLAC, on the basis of official figures.

[a] The Government of Cuba estimates growth of 11.8 per cent for 2005. Since ECLAC does not have its own figures, the calculation for the regional average does not include Cuba. For this reason, ECLAC is currently evaluating the estimate provided by Cuba in accordance with United Nations methodologies.

[b] Estimate.

[c] Projection.

46. Some countries of the region will see the growth rates of their economies begin to return to more normal levels, after having soared in the wake of crises that overtook them at the start of the decade (also explaining the slower growth rate projected for Latin America and the Caribbean in 2006). The region's two largest economies, Brazil and Mexico, will expand at higher rates than in 2005.

47. Although the serious risks facing the world economy have not disappeared altogether, and since imbalances in the United States economy persist, no sudden changes are anticipated in 2006; the global economy is therefore expected to grow at much the same pace as in 2005. Despite the increase in short-term interest rates triggered by the rate increase by the United States Federal Reserve, longer-term rates have changed much less owing to the scarcity of investment plans and, consequently, the weaker relative demand for long-term financial resources. The flattening of the yield curve on international financial markets suggests that profit-seeking on capital markets will help to prolong the favourable conditions now being enjoyed by emerging economies.

48. Thanks to above conditions and the benefits they have yielded for Latin America and the Caribbean over the past few years, the region may be able to further improve its debt profiles and thus continue to reduce its vulnerability to external factors. In many of the countries, the strategy would best be coupled with a continued effort to achieve primary fiscal surpluses, which can then be drawn upon to pay down the debt. In addition, given the current sound fiscal basis, it appears to be a good time for regional Governments to reform the tax structure, in order to ensure that they receive a sufficient inflow of revenues and that those receipts are not dependent upon the price trends of non-renewable commodities.

49. If current forecasts regarding financial returns are borne out, the favourable conditions that emerging markets will continue to enjoy will keep exerting pressure on supply in foreign exchange markets. In such circumstances, the region's central banks will have to work to strike a balance between the need to avoid any loss of

competitiveness and the maintenance of a firm stance in preserving domestic macroeconomic stability.

50. The region's democracies are expected to meet the challenge, as they have in the past, of ensuring that the elections that many of them are holding in late 2005 and 2006 will not negatively influence their macroeconomic situation. However, in order to achieve a growth rate high enough to reduce poverty more quickly, reforms are needed in a number of areas, including the tax structure, social expenditure, regulation and competition in some sectors. The countries should therefore take advantage of the current period of intense political activity to build a broad social and political consensus as a basis for strengthening governance and leveraging the region's future growth prospects by enhancing its ability to attract more investment.

51. In the medium term, the need to maintain a high level of competitiveness calls for a more rapid increase in investment and the use of a policy strategy for enhancing the quality and content of the value that the countries add to their exports. Both elements are necessary conditions for sustaining a growth rate high enough to lower the region's still high levels of unemployment and thus help to mitigate the social imbalances that beset the region.

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Summary of the survey of economic and social developments in the Economic and Social Commission for Western Asia region, 2005-2006

Summary

The economies of member countries of the Economic and Social Commission for Western Asia (ESCWA) continued to grow for the third straight year after two decades of stagnation. This growth, however, is relatively jobless and dependent on one unsustainable trend: a huge surge in the price of oil. Sooner or later, the trend will end, possibly abruptly, and when that happens the drop may be even more acute because resources are being intermediated by speculation on a poorly regulated regional asset market. Had the bursting of the regional stock market bubble coincided with even a moderate drop in oil prices, the negative impact on economic growth would have been severe. Using windfall oil rents to speculate on slowly expanding assets doubly exposes the region to more volatility. Instead of bubble-building in the regional stock markets (some doubling in value in less than a year) and capital diversion abroad, the current relative abundance of capital should offer ESCWA member countries a timely opportunity to implement some of the structural changes that are urgently needed to set the region on the path of rights-based development and employment-intensive growth free from the vacillations in the price of oil.

Failure to take advantage of the current oil boom and reinvest in the region will consign the present surge in rents to a time-bound gain in a way similar to what happened during the great oil booms of the 1970s. The ESCWA region will not be able to leave the lower, short-lived paths of growth and development for higher, sustainable paths if the Governments in the region continue to pursue traditional reforms concentrated solely on improving the business environment, while neglecting targeted public investment. A viable strategy of reform should recognize

* E/2006/100.

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two essential points. First, sustainability of growth cannot be maintained without the effective participation of the citizenry. Reform in public institutions and policies should be carried out with the determined purpose of implementing a rights-based development strategy. Secondly, sustainable growth would be enhanced with the production of some public goods that no single country in the region is capable of producing optimally by itself. These goods have the characteristic of being regional goods, and their optimal production requires regional coordination and cooperation.

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I. Introduction

1. The *Survey of Economic and Social Developments in the ESCWA Region, 2005-2006* outlines a set of economic policy principles formulated to contribute to the design of human rights-based, pro-poor and employment-intensive development strategies in the region. The right to development, in line with the second preambular paragraph of the Declaration on the Right to Development, adopted by the General Assembly in its resolution 41/128 of 4 December 1986, may be defined as a "comprehensive economic, social, cultural and political process, which aims at the constant improvement of the well-being of the entire population and of all individuals on the basis of their active, free and meaningful participation in development and in the fair distribution of benefits resulting therefrom".*

2. These rights-oriented policy proposals are based on three propositions. First, poverty is the most important problem faced by the ESCWA member countries, and its elimination should be their Governments' main priority. This aim is not only significant in itself; it is also mandated by the United Nations through the Universal Declaration of Human Rights, the Declaration on the Right to Development and the Millennium Development Goals. Secondly, rapid and sustained growth, balance of payments equilibrium, inflation control, industrial development and other conventional parameters of economic "success" have limited value in themselves unless they become instruments for the elimination of mass poverty and the achievement of secure, sustainable, equitable and empowering human development in the ESCWA region. Thirdly, macroeconomic policy instruments can make an important contribution to eliminating mass poverty and to bridging the gaping gender divide.

3. From this rights-based, pro-poor viewpoint, the conventional economic strategies employed in the ESCWA region have been largely unsuccessful. The stabilization and structural adjustment policies implemented during the past 25 years have failed to trigger rapid economic growth and a sustained reduction of poverty. Unfortunately, these policies are not self-correcting, and their perceived failure often leads to the intensification of the ongoing structural adjustment programmes.

4. There is both the scope and the urgent need for a shift in economic policy strategies in order to achieve desirable human development goals in the ESCWA region. In this effort, employment creation is the critical link between economic growth and welfare improvement, and it offers an essential platform for the achievement of pro-poor outcomes. The policy principles outlined in this year's *Survey* will be sufficiently flexible to contribute, with suitable adaptation, to the achievement of these desirable outcomes in most countries in the ESCWA region, including the oil-rich, the more diversified and the very poor economies. The *Survey* suggests that this can be done through a combination of rapid, sustainable and employment-intensive growth, and the distribution of income and assets in a regionally designed development compact.

5. Traditionally, macroeconomic policy has been concerned primarily with ensuring macroeconomic stability, with growth and poverty reduction seen as derived goals. This approach has reached its limit. Rights-based poverty reduction

* See also the study on the current state of progress in the implementation of the right to development submitted by Arjun K. Sengupta, independent expert, to the Working Group on the Right to Development of the Commission on Human Rights (E/CN.4/1999/WG.18/2).

objectives should ground national economic policymaking, and play a central role in the selection of the development strategy of the ESCWA region. In line with this approach, the *Survey* examines the interaction between employment, poverty and economic policy, especially fiscal, financial, monetary and exchange rate policy, with the aim of developing the institutional means to generate more employment-intensive growth in ESCWA member States.

6. With unemployment holding steady at the 15 per cent mark after three successive years of cumulative steady growth of nearly 17 per cent, a rights-based development strategy has become not only worthwhile, but urgent. Given the extraordinarily long-entrenched patterns of inequality, in particular gender inequality, in most ESCWA member countries, it has been estimated that the region needs to create 35 million decent jobs during the next decade in order to meet its development targets. The achievement of this goal is complicated by the coexistence of complex patterns of high unemployment with labour export between countries in the ESCWA region, and between these countries and other regions of the world. It could be argued that several countries in the region are in an unemployment trap, which is perpetuated by an undesirable and ultimately risk-enhancing policy compact. Current policies tend to do little to address these urgent problems, are incompatible with the Millennium Development Goals, and militate against international human rights conventions.

7. The implementation of rights-based fiscal, financial, monetary and exchange-rate policies in the ESCWA region requires careful policy coordination at the national and regional levels. It also requires the subordination of these policies to a rights-based development compact and an industrial policy strategy aimed at relieving the supply constraints that currently preclude the welfare improvements rightly expected by the population. The current macroeconomic reform strategy adopted in several countries in the ESCWA region focuses on the adjustment of relative prices and the construction of the institutional edifice into which a thriving market economy is expected to grow, filling up the pre-existing spaces. Experiments have shown that this strategy is flawed because it is impossible to wish into existence an institutionally developed economy, and it is undesirable to attempt to impose economic structures from the outside that may not correspond to the demands, expectations and economic characteristics of the ESCWA region. The *Survey* concludes that economic policies and institutional development must correspond to the peculiarities and the state of development of each country, while at the same time steering the economy towards the fulfilment of socially desirable goals.

II. Recent economic trends and developments in the ESCWA region

A. The global context

8. The world economy continued to expand in 2005, although at a slower rate than the previous year. The United States of America represented the core of world economic growth, while Japan kept up its pace of economic recovery. The European economies showed robustness and stayed on a low but consistent economic growth path. China and India experienced another year of rapid economic growth. Both

countries' presence in the world economy became more visible in determining the demand factors for world flows of goods, services and capital.

9. The undercurrent of the present world economic expansion is held in balance by a rise in commodity and energy prices, including oil and oil-related products, and the high level of liquidity. Although the level of international liquidity has declined from that of the previous year, it remained historically high. The inertia of excess liquidity encompassed financial and real assets, particularly in the emerging markets of developing countries. In the ESCWA region, the bloated regional stock markets are experiencing a crash, which was anticipated in the previous issue of the *Survey*. In comparison with the rapid rise in asset prices, the prices of goods and services have been rising gradually, while high levels of commodity prices have consolidated.

10. As a region of major oil exporters, the ESCWA region benefited from the current global context. For the member countries of the Gulf Cooperation Council (GCC), the oil boom is well into its third year. For the non-oil-exporting countries in the region, this positive external environment sustained their economies in the face of a potentially vulnerable demand structure and ongoing security concerns.

B. Oil sector development

11. As world demand for oil and oil-related products continued to grow, tight supply-demand conditions continued into 2005. Crude oil prices were on a steeply increasing trend throughout the year. A representative brand (West Texas Intermediate (WTI) Cushing) of crude oil averaged US$ 56.6 per barrel in 2005. This is a significant increase from the US$ 41.5 per barrel of the previous year.

12. The near-maximum level of oil production in the ESCWA region continued in 2005, reaching 19.5 million barrels per day, with a slight increase of 2.3 per cent over its 2004 level. The lack of sufficient spare capacities has led to tight oil production in most countries in the region. With the exception of Iraq, the member States of the Organization of Petroleum Exporting Countries (OPEC) in the region (Kuwait, Qatar, Saudi Arabia and the United Arab Emirates) produced 4.7 per cent more than their average crude oil production in 2004. Among the non-OPEC member States in the ESCWA region, Egypt, Oman, the Syrian Arab Republic and Yemen continued to experience a decrease in oil production in 2005, a 2.9 per cent decline from the 2004 level.

13. Gross oil export revenue in the region was estimated at a total of US$ 307 billion in 2005, a 40.4 per cent increase over 2004. For 2006, two scenarios have been projected, relying on the assumption of high and low prices of a barrel of oil. With US$ 52 per barrel for the OPEC basket of crudes price scenario, oil revenues are projected to reach US$ 368 billion, while under a more optimistic scenario of US$ 57 per barrel, they would reach US$ 404 billion.

C. Output and demand

14. The recent global oil boom and high level of liquidity have underpinned strong growth in the ESCWA region. This led to still another good year in terms of overall economic growth; however, the detailed picture is still one of uneven development,

with the wealthy oil economies gaining momentum and the conflict-affected economies suffering from either the immediate effects of political upheaval or the aftermath thereof.

15. The emerging capital markets, stock markets in particular, created a leverage that linked external environments into domestic demands. Positive expectations dominated stocks and real estate markets during 2005. However, the economy as a whole is increasingly vulnerable to developments in stock and property markets. The signs of asset bubbles in the presence of weak regulatory frameworks became more evident in early 2006 and, as envisaged by many, including ESCWA, stock prices crashed in March by immense margins.

16. Gross domestic product (GDP) growth in constant 2000 prices in the ESCWA region (excluding ESCWA members Iraq and Palestine) stood at 6.3 per cent in 2005, compared with 6.4 per cent in 2004. Accordingly, the two ESCWA subregions (the more diversified economies and the GCC members) enjoyed another good year of high real GDP, as can be seen from the table below. Overall, GDP per capita in 2005 increased by an estimated 3.9 per cent, a drop from the 2004 growth rate of 4.2 per cent, which basically reflects the difficult standards of living within the zones in conflict. The region's population growth rate has remained more or less constant at the 2.4 per cent level over the past few years.

17. The fact that the short-term business cycle fluctuations in the region remain closely tied to developments in the oil market means that it will be difficult to make accurate predictions of future performance, especially when wealth intermediation through the poorly regulated stock market accentuates the volatility of the cycle. In a sense, the region's economy is becoming more volatile on account of oil price fluctuations and expectations built on bubbles in the stock markets that burst. Official GDP estimates of recent years in some ESCWA member countries were revised upwards, which suggests that the magnitude of the current boom is prone to misdiagnosis, particularly in the absence of reliable regional data. Nevertheless, should the current range in oil prices prove short-lived, economic expansion is forecast to taper off during 2006, with the overall GDP growth rate for all countries predicted to reach 5.4 per cent, a 1 per cent drop from the 2005 high growth rate.

18. Overall real GDP growth rates in the GCC members have hovered around 7 per cent during the past two years, whereas the per capita GDP rate remained at 3.9 per cent in 2005 compared with 4.0 per cent in 2004. The realization of the rent and wealth effect, the latter component leveraged through stock markets, was evident in this subregion, with sustained business and consumer confidence. The demand-led part of the economic expansion has benefited the non-oil private sectors, mainly in banking services, trade, and construction and real estate. Although the private sector has become increasingly sensitive to stock and property market developments at this stage, the lagged effect of public expenditures, together with the multiplier effect, will sustain domestic demand in 2006. In most GCC members, large public investment projects are planned, budgeted or being partly implemented. The growth rate of this subregion is forecast at 5.8 per cent for 2006, allowing for the effects of the financial markets' collapse of March 2006 on investment and growth.

Table

Annual average percentage change in GDP growth and inflation rates in the ESCWA region, 2002-2006

Country/area	Real GDP growth					Inflation rate[a]				
	2002	2003	2004	2005[b]	2006[c]	2002	2003	2004	2005[d]	2006[e]
Bahrain	5.2	7.2	5.4	6.2	6.3	(0.5)	1.6	2.4	3.3	1.6
Kuwait	(2.0)	12.7	16.3[f]	6.5	4.1	0.9	1.0	1.3	4.2	1.8
Oman	2.6	2.0	5.6	4.2	5.5	(0.7)	(0.3)	0.4	1.9	1.1
Qatar	7.3	5.9	8.7	7.6	8	0.2	2.3	6.8	8.8	2.7
Saudi Arabia	0.1	7.7	5.2	6.8	6	0.2	0.6	0.3	0.7	1.0
United Arab Emirates	3.0	12.2	7.5	8.0	6	2.9	3.1	4.7	5.4	4.5
Gulf Cooperation Council countries	1.1	8.7	7.2	6.9	5.8	0.8	1.3	1.8	2.7	2.0
Egypt	3.1	4.2	4.9	5.5	4.6	2.7	4.2	10.8	3.1	8.0
Jordan	5.7	4.1	7.7	7.3	5.6	1.8	1.6	3.3	3.5	8.4
Lebanon	(1.3)	3.0	5.0		3	4.3	3.0	2.4	1.9	2.0
Syrian Arab Republic	5.9	1.1	2.0	4.0	3	1.0	4.8	4.6	4.0	5.0
Yemen	3.5	3.8	3.9	4.6	4.2	12.2	10.8	12.5	5.6	11.4
More diversified economies	3.2	3.6	4.6	4.8	4.3	3.2	4.4	8.8	3.3	7.3
ESCWA region[g]	1.8	7.1	6.4	6.3	5.4	1.5	2.2	3.9	2.9	3.5
Iraq[h]	(6.9)	(33.1)	23.0	10.0	7	19.3	33.6	27.0	37.0	12.0
Palestine	(3.6)	(0.1)	2	4.9[i]	(0.8)	5.7	4.4	3.1	3.5	3.1
Total ESCWA region	**1.3**	**5.2**	**6.8**	**6.4**	**5.4**	**2.2**	**2.9**	**4.6**	**3.9**	**3.8**

Source: ESCWA, based on computations of growth rates from real GDP figures at constant 2000 prices. The latter are taken from national sources and official figures as provided by answers to questionnaires of the *National Accounts Studies of the ESCWA Region, Bulletin No. 25*.

[a] Subregional average inflation rates are weighted average, where weights are based on GDP in constant 2000 prices.

[b] ESCWA estimates, February 2006.

[c] ESCWA projections, February 2006.

[d] Estimates for 2005 based on official preliminary figures.

[e] International Monetary Fund, World Economic Outlook Database, September 2005. However, ESCWA estimates higher inflation rates generally, especially for Qatar.

[f] From official figures. It should be noted that the bulk value of the increase in official data was in mining and quarrying, and real value added grew by 34.9 per cent while oil output grew by 7.9 per cent only.

[g] Excluding Iraq and Palestine.

[h] Rates for Iraq are based on official sources except for 2005 and 2006, which are ESCWA secretariat estimates.

[i] Latest (February 2006) figures from the Palestinian Central Bureau of Statistics.

19. The subregion, comprising the more diversified economies, was able to maintain its gradual acceleration in economic expansion during 2005. Although some positive developments in the manufacturing sector were seen in Egypt and Jordan, this subregion's growth in the current positive cycle has continuously been

led by private consumption. Favourable external conditions, a high level of global liquidity, rapid growth in trade in such services as tourism, and a stable inflow of workers' remittances from abroad loosened those countries' foreign exchange constraints, which allowed demand expansion to take place at a rapid pace. Moreover, this positive external economic condition assisted Lebanon in avoiding a large decline in its economy in the face of a deteriorating security situation after February 2005. The subregion's real GDP growth rate recorded 4.8 per cent, the highest rate attained since 2000. Likewise, its overall per capita income soared to 2.5 per cent.

20. Security-related tensions persist in the conflict-affected economies. This situation will blight any prospects for socio-economic stability in Iraq and the Occupied Palestinian Territory, and has already led to negative per capita growth in the Occupied Palestinian Territory, as well as inducing widespread poverty. Continued armed attacks on an already weak oil infrastructure and other deteriorating security conditions in Iraq led to a decrease in oil production in 2005. Consequently, Iraq failed to sustain the pace of economic recovery witnessed in the previous year. Its real GDP growth in 2005 was estimated at 10 per cent, lower than the 23 per cent recorded in 2004. Likewise, Iraq's per capita GDP declined to 7.1 per cent from 19.6 per cent in 2004. The Palestinian economy experienced weak economic growth in 2005. Real GDP growth in Palestine was estimated at 4.9 per cent in 2005, up from 2 per cent in 2004; GDP per capita growth was 1.6 per cent in 2005 after negative values for the previous three years. The slowdown in economic growth can be attributed to closures by the Government of Israel through the imposition of the "separation wall", which has impeded labour and trade flows. Living standards are expected to remain below potential in both economies unless the political situation stabilizes with active international support.

D. Costs and prices

21. Both external and internal factors spurred rising prices in the ESCWA region. Import prices in petroleum products and other commodities increased, while internally the rising rents stemmed from the hike in asset prices that affected general price levels, particularly in the GCC countries. The average official inflation rate for the ESCWA region was 4 per cent in 2005, although it should be noted that the weighting system of the consumption bundle in many member countries does not fully reflect the actual rise in prices. Within the ESCWA member countries, "official" inflation rates ranged from a low of 0.7 per cent in Saudi Arabia to a high of 8.8 per cent in Qatar, with the exception of Iraq, which experienced an inflation rate estimated at 37 per cent.[1] In Egypt, average inflation rates declined from 10.8 per cent in 2004 to a mere 3.1 per cent in 2005. This is mainly due to the real appreciation of the domestic currency against the United States dollar and the increased effectiveness with which monetary authorities have been able to control liquidity. In Iraq, serious energy shortages and a reduction of energy supplies drove up average prices at end-2005 while the reduction of energy subsidies late in 2005 further spurred inflation during the first quarter of 2006.

[1] For an overview of the estimated inflationary gap in the ESCWA member countries, see the *World Economic Situation and Prospects 2006* available at http://www.un.org/esa/policy/wess/wesp.html.

E. Labour markets

22. Economic growth was unable to make a dent in the region's high unemployment rate, especially the high rate of unemployment among young people, which has led to feelings of despair. The labour market in the ESCWA region is experiencing a glut, due mainly to the high rates of new entrants and low job creation. Although regional labour market statistics are sketchy, high unemployment rates remain a serious concern, with estimates of unemployment hovering at the double-digit level in most ESCWA member countries.

F. External sector

23. The total gross value of merchandise exports, including re-exports, of ESCWA member countries in 2005 was estimated at US$ 462 billion, while the total gross value of merchandise imports was estimated at US$ 273 billion. The GCC members account for 87 per cent of those exports and 71 per cent of total imports. Oil and oil-related products continued to be the major export product group of the ESCWA region. Despite the current rise in oil prices, in 2005 the share of oil exports in total exports, 65 per cent, barely changed from the previous year. It is evident that non-oil exports were growing at the same rate as oil exports. Among others, the apparel sector in Jordan and the steel sector in Egypt became established as export revenue earners for their respective countries.

G. Economic policy developments

24. Long-term development priorities require active fiscal expansion, which is at odds with the current short-term stabilization measures. However, in view of the rapid rise in domestic asset prices and inflationary pressures from external factors, Governments must re-engineer their fiscal policies to attenuate the speculative impact and possible downswings in domestic demand levels. The Governments of the GCC countries shifted their fiscal stance to a more active one, though still within the limits of prudential fiscal management. The Governments in the more diversified economies were continuously at their fiscal ceiling, and prioritization within their fiscal constraints became more difficult, particularly in view of the rise in energy prices.

25. The central banks of the GCC countries warned of possible "asset bubbles" and, in addition to increasing interest rates in parallel with the United States Federal Reserve, other monetary measures, such as restrictions on lending for speculation and open market operations, have been taken to contain excess liquidity. However, the difficulties lay in the nature of selective demand management during the boom period, which proved difficult, and the effect of the measures was limited. The inflexibility in policy stemmed from the pegging of these countries' national currencies to the United States dollar. Central banks in the more diversified economies successfully managed their foreign exchange position, albeit without much impact on domestic demand.

26. The *Survey* notes that rights-based strategies require the regulation of the capital and financial accounts of the balance of payments. Capital account liberalization can be highly destabilizing for the poor and middle-income countries in the ESCWA region. Unbridled capital account liberalization fosters the

accumulation of excessive foreign debt, promotes speculative capital flows that finance consumption more than investment, increases a country's vulnerability to balance of payments crises, and facilitates capital flight. In spite of the conventional insistence on capital account liberalization, this strategy does not contribute to macroeconomic stability and, even if it does raise the economic growth rate in the short term, this effect tends to disappear in the medium term. In this context, balance of payments instability can be especially damaging for the poor.

H. Prospects

27. The ESCWA member countries tend to be net food importers, which is one key reason for their balance of payments constraints. Climatic and geological features strongly limit the availability of natural water in several countries, and impose high costs on agricultural production, which, in turn, contributes to poverty, especially in the countryside. These difficulties are made worse by the inefficiency of delivery mechanisms and the high levels of water wastage in several countries. The combination of natural factors, oil price volatility and geopolitical tensions explains why the human development performance of the ESCWA member countries has been less than satisfactory. It also helps to put into context the rigidity of economic, social, political and institutional structures, the structural insecurity, and the difficulty of reforming policies in order to achieve economic growth, stability and rights-based development. These reforms will remain essential even if the current oil boom proves lasting. The current social, economic and institutional structures are conducive to capital leakages and destabilizing bubbles in real estate and equity markets, both in the oil economies and in the more diversified economies. In order to achieve sustainable growth and economic diversification, reduce unemployment and support rising living standards, as part of a rights-based development strategy, a significant volume of additional resources needs to be deployed within an industrialization strategy for the region. In addition to this, the countries of the region urgently need to consider their future after the exhaustion of oil and/or its rents.

III. A rights-based, pro-equity macroeconomic framework

28. The main objectives of the policies outlined in the *Survey* are as follows. First, it is important to increase the degree of coordination across different policy areas in the ESCWA region, including industrial, trade, monetary, financial and exchange rate policies. Secondly, it is crucial to restrict the openness of the capital account of the balance of payments in the countries in the region, in order to expand the policy space available to the regional Governments. Thirdly, the fiscal space available to ESCWA member countries should be expanded in order to facilitate the mobilization of the existing rent flows and maximize future growth, in order to pursue socially desirable goals. Fourthly, productivity of resources in the ESCWA region must be increased, and there must be limits on the ability of elite-driven financial systems to control domestic credit, the financing of the State and the balance of payments. These policies can contribute to the achievement of rights-based development objectives and are urgently needed, because failure to shift economic strategies at this relatively favourable moment, with high oil prices, may lead not only to further capital flight, but also to macroeconomic instability. More important, a failure to act

would squander a rare opportunity to achieve important objectives at a relatively low cost.

29. The choice between mainstream and rights-based fiscal and monetary policies involves not only their internal consistency, but also the political constraints influencing the selection of economic policy in each country. More specifically, the most important constraint hindering the introduction of pro-poor strategies in many ESCWA member countries is not resource scarcity or the lack of government capacity. Rather, it is the lack of political will to confront the internationally dominant conventional policy consensus and build alternatives based on the collaborative efforts of national Governments, private capital and civil society.

30. A pro-equity macroeconomic framework for the ESCWA region should include three goals. It should: (a) keep the growth rate well above the rate of population increase; (b) substantially reduce the variability of growth; and (c) foster a more equitable and employment-friendly growth path. The simplest element to specify is how to raise the growth rate. Setting aside exogenous factors such as the effects of political instability, the major limitations to faster growth are: (i) restrictive fiscal policy; (ii) contractionary monetary policy; (iii) low rates and poor quality of investment; and (iv) in some countries, a balance of payments constraint. For the purpose of this summary, only the major issues raised in fiscal and monetary policies are outlined below.

A. Fiscal policy

31. Converting a restrictive fiscal policy to an expansionary one could be achieved through an employment-intensive public investment programme to expand the physical and social infrastructures, financed by oil rents or borrowing, increased development assistance and debt relief. A growth-accommodating monetary policy requires using the interest rate as a long-term investment instrument rather than for short-term stabilization; which means a relaxation of inflation-targeting be it explicit or implicit. For non-oil exporters, the balance of payments constraint could be relieved by interventions to establish a stable and moderately undervalued real exchange rate. Also for the more diversified economies, GCC development assistance could provide support during the transition towards a stronger export performance.

Current pro-cyclical fiscal and monetary policies

32. The fiscal and monetary policies in almost all stabilization and structural adjustment programmes have been pro-cyclical, when they were not continuously contractionary, exacerbating the world market factors that destabilize the ESCWA region. Reversing this policy is not a simple matter of increasing expenditure. A growth-fostering pro-equity fiscal policy package requires more public expenditure of a particular type: well-conceived public investment, which can achieve the three necessary elements of such a package, including (a) demand expansion; (b) supply enhancement; and (c) redistribution. In the absence of a robust public investment programme, the pro-equity element in fiscal policy would consist of social expenditure, counter-cyclical measures and progressive taxation. While each of these is important, in many developing countries the capacity of ESCWA member countries to intervene counter-cyclically is limited.

33. More important, basing redistribution on the current budget is not a growth strategy. If sustained, it may create a new, more equal distribution towards which the economy will move. However, except for a possible one-off impetus resulting from the positive incentives to the poor of the redistribution, it has little impact on the sustainable growth rate. For this reason, well-conceived public investment is the sine qua non of a pro-equity growth strategy, and the reduction of public investment undermines that strategy.

Public versus private investment

34. The emphasis placed on public investment requires consideration of one of the major arguments against it, so-called crowding out. The argument that public investment in the ESCWA region would crowd out private investment is somewhat unfounded. It is typically the case that those who make this argument also urge Governments to undertake major policy changes to encourage inflows of foreign investment, usually without expressing strong concern that the latter might crowd out private domestic investment. It is recalled that crowding out occurs when an economy is near full employment. When there are unutilized resources, there is economic space for an increase in all types of expenditure, both public and private. Even if crowding out occurs under full employment, it is unlikely to be complete. As a consequence, public investment would be growth-inducing, both in its demand and capacity effects, unless the return on the marginal private component was higher than the return on the public component by an amount that would make the impact on growth negative.

35. Crowding out due to the introduction of public investment will reduce the rate of growth if — and only if — public investment is more capital-using than private investment. If the capital-output ratio for public investment is smaller than for private investment, public investment never reduces the growth rate. If crowding out is total, the growth rate falls only if public investments are more capital-using than private ones. Thus, public investment causes a negative impact on the capacity-creating source of growth only under very restrictive conditions in which crowding out is total and private investments use less capital per unit of output, which is empirically not the case in the ESCWA region. The former condition is unlikely, and the latter can be avoided by public choice of investment projects. In addition, employment-intensive public works that have already been implemented can provide practical guidelines to ensure that some public investments are not excessively capital-using.

36. What is more pertinent to the ESCWA region crowding-out case is that a substantial part of private sector investment in the region either does not borrow for investment, or does not do so in the financial markets that would be affected by government borrowing. Investment by small producers, rural and urban, is often self-financed, or financed from indigenous lenders with little connection to the formal banking system. Foreign investment, to the extent that it is important, is not typically financed from domestic financial markets.

37. Targeted public investment into pro-poor areas can boost aggregate demand (potentially sparking the recovery of a stagnant economy), loosen the supply constraints on long-term growth and help the reallocation of resources to achieve poverty reduction objectives, especially in economies operating below potential, as is the case in most ESCWA member States. There is empirical evidence in the

region indicating that public investment generally "crowds in" private investment in upstream and downstream sectors (for example, supplies of inputs and consumables, cleaning, maintenance and security services, trading and finance, and workforce training). Public investment can also support private investment and output growth if it expands a country's physical infrastructure (roads, ports and airports, water, sewerage and irrigation systems, electricity-generating capacity and transmission lines), boosts labour productivity (in particular, through public education and training programmes, public transport or public health provision), or if it fosters private savings. When public investment falters, aggregate profits decline, reducing both the incentives and the resources available for private investment. Public investment can also support quality foreign investment. Evidence also shows the following: first, that public investment has played a key role in fostering growth and reducing poverty in several dynamic economies, especially in East Asia; and second, that when public investment declines, private sector profitability often declines, reducing the resources available for investment. In this sense, adequate levels of public investment can be essential for sustained pro-poor and rights-based growth, especially in the resource-constrained more diversified economies in the ESCWA region.

More proactive economic policies

38. In order to support economic stabilization and large public investment programmes, the Governments of the region's more diversified economies need to discard the excessively restrictive fiscal policy stance imposed by conventional economic strategies and adopt more proactive policies. This is not necessarily inflationary: in the ESCWA region, there is no evident relation between fiscal deficits, growth, unemployment and inflation. In other words, public investment programmes can be deficit-financed, as long as these deficits are not excessive, the economy is operating below capacity, the balance of payments constraint is not binding, and the deficits can be financed in a sustainable manner (if the additional domestic debt of the public sector can be paid off by the tax revenues generated by future growth). However, if the Government needs to monetize its deficit because, as in most ESCWA member countries, the financial markets are insufficiently developed, or because debt finance may have adverse distributive implications, care must be taken to limit the ensuing expansion of demand because of its potentially adverse implications for inflation and the balance of payments. Even though this is reassuring, it is better to err on the side of stability rather than to generate unsustainable disequilibriums, especially in view of the large social and investment programmes required by a pro-poor growth strategy in the ESCWA region. Experience indicates that if public deficits are used to finance investment that expands aggregate supply, and as long as they are financed in a sustainable fashion, their impact should not be unduly inflationary either in the short or the long term.

Pro-poor investment

39. Pro-poor public investment in the ESCWA region should target the following priority areas: (a) infrastructure provision; (b) rural and urban slum area development; and (c) education and health. In most ESCWA member countries, it is especially important to support the development of agriculture and its linkages with other economic sectors for three reasons: (i) its current economic importance; (ii) the fact that large numbers of poor people live in rural areas; and (iii) the potentially

severe dislocations to labour and agricultural production due to trade liberalization. The more diversified economies in the ESCWA region can draw upon the Chinese, Indonesian and Vietnamese strategies implemented between the 1970s and the 1990s, as they attempt to raise agricultural productivity, boost the links with agriculture and other dynamic economic activities and increase the scope for the production of exportable goods. In order to do this, it may be necessary to transform significantly the land tenure systems in these countries and invest heavily in better technology and in physical and social infrastructure, including better seeds and fertilizers, improved crop selection, irrigation, storage and transport facilities. Public investment in rural development, especially in the Mashreq region, can focus on the diversification of agriculture into labour-intensive high-value agricultural commodities such as horticulture and livestock for increased profit incentives and employment opportunities. Labour-intensive development programmes for urban slums should also be fostered in view of the large degree of urbanization in the more diversified economies.

40. The expansion of low-productivity small-scale labour-intensive sectors, such as family agriculture and small and medium-sized enterprises, in urban areas is unlikely to deliver the employment and productivity growth required for the long-term success of a pro-poor development strategy. These sectoral initiatives must be plugged into broader programmes of education, training, technological development and labour transfer to high-productivity sectors, in order to deliver higher productivity and better living standards for the poor.

41. Another priority area for public investment is technological upgrading, especially in the manufacturing industry. The ESCWA member countries need to upgrade their productive capabilities because productivity gains are the key to sustained growth and rising incomes in the long run. These gains can be achieved in at least two different ways. One is the development of mass production facilities where low-paid unskilled workers engage in repetitive tasks at high speed in traditional plantations, or in manufacturing industries producing clothing, shoes or established electronic products, as in the *maquiladoras* in Mexico or in most Asian export-processing zones. Alternatively, better-paid skilled workers could be expected to work cooperatively and apply more sophisticated technical skills in the service industry, in specialized agricultural production or in the manufacture of relatively sophisticated electronic goods, chemicals and machines. Obviously, most ESCWA member States cannot move directly into these advanced production processes because they lack the technology, infrastructure, skills, managerial capacity and finance to do so. However, this type of development is precisely that which rights-based and pro-poor strategies should aim for, even if they are achievable only in the medium and the long run, and only in certain areas of the economy. They should serve as a growth engine that pulls other sectors and labour forces forward.

42. The final priority area for public investment is the promotion of non-traditional exports. The literature on industrial policy shows that the expansion of exports can make an important contribution to productivity growth because it exposes producers to the stringent test of foreign market access. Export growth is also essential for the generation of healthy trade surpluses and the accumulation of foreign currency reserves, which will support the stabilization of the exchange rate in the more diversified economies. In the absence of sizeable currency reserves obtained through trade surpluses, the more diversified economies will always be

compelled to seek less desirable forms of international finance, especially aid and portfolio capital inflows, or borrow from the international financial institutions, whose conditionalities might limit their ability to pursue rights-based policies. Export growth in the medium and long run requires a competitive and stable real exchange rate, as well as coordinated industrial policy initiatives to develop a country's competitive advantages in strategically important sectors. The Government will need to become involved in the complex task of choosing the right sectors and encouraging private investment therein, a challenge which has been addressed successfully by several countries in East Asia and elsewhere over long periods of time.

Financing through taxation

43. The ESCWA secretariat suggests that these policy priorities be funded primarily by local (national or regional) sources. Raising resources locally to support a rights-based development strategy will require a concerted effort since, in many ESCWA member States (not necessarily the poorest), the retained portion of savings and tax revenues are insufficient to support ambitious pro-poor programmes. Private sources of finance will require support from additional public sector spending. These additional expenditures should be financed primarily by taxation rather than debt. In most ESCWA member countries, there is a large untapped potential for raising taxes, since tax ratios are often markedly below 20 per cent of GDP. In most countries, taxation is almost exclusively based on indirect taxes (including taxes on oil), which helps to consolidate the inequalities that currently structure these economies. Some GCC countries levy no income tax at all, and enforcement across the region tends to be so lax that the equalizing impact of taxation is often even more limited than it initially appears to be. In addition to this, a large part of the taxes that are actually collected tend to be wasted from the point of view of their pro-poor impact because of regional political instability factors. Countries including Jordan, Oman, the Syrian Arab Republic, the United Arab Emirates and Yemen allocate at least a quarter of their central government budgets to defence spending. In fact, there tends to be a systematic pattern of substitution between defence and social spending.

44. Achieving the required levels of sustainable public spending will require significant modernization and expansion of the tax systems of ESCWA member countries, as well as improvements in tax collection and administration, in order to raise additional revenues and improve the distributive impact of taxation. Tax revenues play a fundamental role in the mobilization of resources for the allocative, distributive, growth and stabilization functions of the State, especially in countries with weak financial systems. Investment in tax collection and administration can bring high returns to the Government, and a pro-poor tax system will play an essential role in supporting the improvement of social welfare in the long run. In order to fund growth-accommodating and pro-poor fiscal policy and distribute income while maintaining macroeconomic stability, most ESCWA member States will need higher and mildly more progressive tax rates, including a shift away from indirect taxation and towards direct (progressive) taxation. It will also be necessary to expand the tax base through the taxation of wealth, large or second properties in rural and urban areas, unearned incomes (especially interest and capital gains), financial transactions and international capital flows. The most important constraint on the expansion of the tax base in the ESCWA region is not economic or

managerial (although these obstacles are relevant, especially in economies with large informal sectors), the constraint is primarily political. However, domestic pressures for economic privileges or threats of capital flight should not prevent the State from mobilizing domestic resources, especially when they are based on rents.

B. Monetary policy

Inflation targeting

45. Perhaps the most concrete application of the price-determined, as opposed to demand-determined, framework manifests itself in the policy of "inflation-targeting". Within this framework, every economy is presumed to be in, or moving towards, general equilibrium, and inflation is the result of expectations and "random shocks". In other words, inflation has no structural cause; it follows from people's anticipation of it, and this anticipation is primarily the result of government behaviour. In its most inflexible form, inflation-targeting involves assigning to the central bank the mandate to use its policy instruments to realize an inflation rate below a specific rate. The instrument used to "hit" the target is almost always the nominal interest rate. In the practices of ESCWA member States, attempting to fulfil such a mandate overrides all other policy objectives, be they short-, medium- or long-run; it means achieving a competitive exchange rate, stimulating investment, and managing the budgetary cost of the Government's debt.

46. The prevailing argument in the ESCWA region in favour of inflation-targeting is that its success, a low inflation rate with a small variation, would foster growth by providing a stable macroenvironment for private investment. There are two issues here: the effect and wisdom of targeting as such, and the inflation rate to be targeted. It can be pointed out that consideration of the alleged positive benefits of inflation-targeting requires a prior acceptance that the policy is feasible, that is, that most central banks in the region could, by use of the monetary instruments available to them, realize a predetermined rate of inflation and maintain it with small variability. This proposition is not credible, however, because of the large and unavoidable random "shock" (namely in oil prices) element in policy outcomes in the ESCWA region.

47. Despite the recessionary consequence of choosing a low numerical target and attempting to achieve it in the context of severe random oil shocks, many external assistance agencies vigorously defend the policy for inflation reduction as such. What might be called the "bottom line" defence is that "inflation is bad for the poor"; therefore, inflation-targeting is "good for the poor". A cursory review of the data on the country level shows that there is little evidence to support this in the ESCWA region. Other empirical studies of the distributional impact of inflation found that "though in high inflation countries restrictive monetary policy is often beneficial for inequality, reducing inflation in economies with initially low inflation might increase inequality".[2]

48. Rights-based anti-inflation programmes in the ESCWA region recognize the costs of inflation for the poor, in terms of their income levels and the distribution of

[2] Rossana Galli and Rolph van der Hoeven, "Is inflation bad for income inequality: The importance of the initial rate of inflation", Employment Paper 2001/29 (Geneva, International Labour Office, 2001).

income, as well as the costs for the poor of the traditional inflation stabilization strategies. They should also take into account empirical evidence showing that stable moderate inflation may have no adverse macroeconomic consequences, and that the obsession with very low inflation can be bad for the poor because it is associated with slow growth, high unemployment and high interest rates for long periods. None of these arguments indicates that inflation is "good". Rather, the arguments highlight the fact that there may be choices to be made about the priority and intensity to be given to inflation control. These are not simply "technical" issues, and the benefits of very low inflation do not necessarily trump every conceivable alternative, every time.

Need for coordination of policies

49. Rights-based anti-inflation policies in the ESCWA member countries should involve a broad range of policies deployed in close coordination, including fiscal, monetary, income, price, industrial and exchange rate policies. In contrast, the strategies practised tend to rely primarily on one or two relatively blunt policies, in particular fiscal austerity and interest rate manipulation. This difference arises because rights-based anti-inflation policies address the causes of structural (long-term) inflation which, especially in the more diversified economies in the ESCWA region, tends to be located on the supply side of the economy. In contrast, inflation in the oil economies tends to be closely correlated with their balances of payments. Mainstream anti-inflation strategies focus on the monetary symptoms of inflation and its propagation mechanisms, leading to their almost exclusive policy focus on the demand side of the economy. However, addressing the causes of inflation normally requires an ample set of economic policy tools, backed up by negotiations to coordinate sectoral income demands and defuse the existing distributive conflicts. Rights-based anti-inflation policies should also seek to promote the Government's long-term growth and equity objectives, rather than subordinating all State policies to the goal of inflation stabilization. The combination of a wide variety of policies and the protection of the pro-poor goals of Governments can facilitate the involvement of society in the pursuit of low and stable inflation. This is essential because, in the absence of a broad-based commitment to macroeconomic stability, the Government would have to deploy imperfect instruments with insufficient information, possibly against unwilling social sectors, in order to impose its objectives upon society. This would increase the cost of inflation control and, in all likelihood, reduce the welfare of the majority.

50. In summary, low inflation can be achieved at an acceptable social cost, but this requires more than controlling public spending, limiting the supply of money or jacking up interest rates. Low and stable inflation is the outcome of long-term economic development and a social commitment to price stability, which should be part of a rights-based development compact in the ESCWA region. Social cooperation and policy coordination can foster an environment in which society is committed to low inflation, where economic patterns of behaviour are broadly compatible with this objective and where government policy contributes directly to this outcome. This will reduce the scope and the need for central bank discretionary action, especially arbitrary changes in interest rates that can create uncertainty, deter investment, generate unemployment, and impose obstacles to the achievement of pro-poor objectives such as the Millennium Development Goals. In a pro-poor policy framework, inflation control is not the province of a single government

institution such as the central bank or the ministry of finance; it is a strategic national objective that will support the achievement of rights-based development.

51. The structural characteristics of ESCWA member States make mandated targeting either unfeasible or undesirable, or both. What is both feasible and desirable would be a political commitment to poverty reduction, with each aspect of macroeconomic policy assessed ex ante and ex post for its poverty impact, and with these assessments subject to public scrutiny. One manifestation of the commitment could be a poverty assessment of the annual budget.

C. Conclusions

52. Liberated from the straitjacket of tight inflation-targeting, monetary policy could contribute to pro-equity growth. Used as the major instrument for macroeconomic management, monetary policy can do little to make growth pro-poor. However, in support of an expansionary fiscal policy it can indirectly foster growth that is pro-poor. As a general rule, if inflationary pressures are weak, this support would take the form of positive but low real interest rates and an expanding monetary supply. However, interest rates should not be so low as to induce high capital-intensity in future output.

53. While these guidelines appear simple, their application in Western Asian countries is not straightforward. In all the countries in the region, financial markets are underdeveloped, though some exhibit certain forms of financial intermediation. The concrete result of underdeveloped financial markets and conditions of regional instability is that Governments find it difficult to sell their bonds to private agents. This explains the common practice in the region of legislation that requires commercial banks to hold a portion of their reserves in government bonds. In practice, this requirement has tended to have an anti-poor bias, because it redistributes general revenue to the wealthy as interest payments.

54. Narrow financial markets imply that the effectiveness of monetary policy to pool savings, stimulate private investment and influence/guide its allocation patterns is low. However, the limited ability of the central bank to stimulate investment does not imply that there is no pro-equity role for the central bank rate. Lower central bank rates would have two pro-equity effects: (a) government bonds are held by the wealthy, or the institutions of the wealthy, so lowering rates would have a positive impact on income distribution; and (b) lower rates imply a smaller domestic debt service in the public budget, producing "fiscal space" for pro-equity government expenditure.

55. Allowing the money supply to expand moderately faster than real output can also have a pro-equity impact, by increasing access to credit in "informal" financial markets. It also encourages financial "deepening", that is, the ratio of the money supply to aggregate output, which is typically low in the ESCWA region. Money supply management raises the question of what instruments would be used to counter inflationary pressures if these became a serious policy concern. The key policy issue is what constitutes a "serious concern". Cross-country regressions suggest that inflation is uncorrelated with growth for the rates that characterize the ESCWA region. Therefore, if growth and poverty reduction are the goals, a tolerance for moderate inflation is required. This is especially the case because,

owing to the weakness of financial markets, the only effective instrument for reducing inflation in most countries would be fiscal contraction.

56. In summary, a pro-equity monetary policy requires low real interest rates, a tolerance for moderate inflation rates, and an expansion of the money supply that accommodates growth and financial deepening. To achieve these outcomes when private banks set exorbitant interest rates, it probably would be more pro-equity to finance prudent fiscal deficits by monetization rather than by bond sales, which redistribute income to the wealthy.